

**MANAGING PERMANENT ESTABLISHMENT RISKS IN MULTINATIONAL
ENTERPRISES IN POST-BEPS ERA**

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Abstract

The objective of this thesis is to identify the main PE risks faced by multinational enterprises at different stages of value chain with a focus on distribution and to suggest ways to address these risks to ensure tax compliance in multiple jurisdictions. The term “PE risk” in this paper means the risk of failure to comply with applicable regulations in identifying permanent establishment in situations where certain business activities of the enterprise are held outside the country of its tax residence.

The thesis is done by conducting a literature review and structuring the results under risk management methodology. This research focuses on the substance of the PE concept under the OECD Model Tax Convention. It does not cover procedural aspects of profit attribution to PE nor dispute resolution mechanisms.

Previous research has uncovered the challenges in balancing roles of the PE concept in ensuring both sufficient tax revenue and flexibility for taxpayers. The complexity theoretical approaches to the PE concept in the OECD Model is multiplied by diverse sources of law that may define the presence of PE on a case-by-case basis: supranational regulations (e.g., the EU law), bilateral and multilateral tax treaties, domestic laws, and often unpredictable case law. Comprehensive tax risk management framework should ensure that MNE will not overlook risks that are likely to happen due to communication failures, agency problems, or misunderstanding of applicable regulations. keystones of an efficient tax risk management framework are effective business model tax risk assessment based on accurate and detailed document management and clear communications on tax compliance goals and risks among multiple stakeholders.

Keywords permanent establishment, double taxation, BEPS, Action 7, OECD Model Tax Convention

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1. INTRODUCTION

1.1. Background of the study

The primary ways to define the right to tax an enterprise on its profits arising from the territory of a specific country are to consider whether the foreign company as a resident or having a permanent establishment (PE).¹ The concept of permanent establishment (PE) determines whether an enterprise has sufficient activity in another territory to create a taxable presence there and thus to justify that country's taxation of the business profits.²

Governments aim to prevent companies from artificial channelling of the profits to entities in low-tax jurisdictions, as corporate tax revenue losses can amount to 4-10% of all global tax revenues (USD 100-240 bn annually).³ The reasons for these losses are aggressive tax planning schemes and challenges brought by domestic laws and their practical implementation by tax administrations.⁴ Globalisation and digitalisation advancements make it easier to find legislative loopholes and plan the tax avoidance schemes. In recent years, Action 7 of OECD Base erosion and profit shifting (BEPS) projects have resulted in a significant expansion of the PE definition, and especially in lowering the threshold for PE created by dependent agents.⁵

As a result, MNEs are facing a growing need to assess where PE risks come from and what PE risks are materializing, as well as the need to develop approaches to managing PE risk, either by ensuring that no PE arises, or by assessing the level of profit that could be attributable to it. This would allow MNEs to satisfy diverse and sometimes unpredictable requirements of local tax authorities. PE risk management also becomes one of the priority services provided by consulting and audit companies.⁶ For this reason, identifying and managing PE risks is vital for multinational enterprises to stay compliant with the diversity of local laws and tax treaties when operating globally.

1.2. Research objective, questions and structure

¹ Antti Tokola, "The Implementation of the Controlled Foreign Company Rules in the EU Anti-Tax Avoidance Directive in Finland, Luxembourg and the Netherlands – The Effects on the Holding Company Structures of Finnish Groups" [2018] 72(3) Bulletin for International Taxation 173

² Yasin Uslu, "An Analysis of "Google Taxes" in the Context of Action 7 of the OECD/G20 Base Erosion and Profit Shifting Initiative" [2018] 72(4a) Bulletin for International Taxation IFBD accessed 20 October 2018, citing International Tax Glossary, Glossary IBFD.

³ OECD, *OECD/G20 Base Erosion and Profit Shifting Project. Explanatory Statement* (2015) 4 <<http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>> accessed 20 October 2018

⁴ OECD, *OECD/G20 Base Erosion and Profit Shifting Project. Explanatory Statement* (2015) 4 <<http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>> accessed 20 October 2018

⁵ OECD, BEPS Action 7 Additional Guidance on Attribution of Profits to Permanent Establishments. Discussion Draft (2017) 5 <<https://www.oecd.org/tax/transfer-pricing/beps-discussion-draft-additional-guidance-attribution-of-profits-to-permanent-establishments.pdf>> accessed 20 October 2018

⁶ Michael Cooper, "BEPS: Permanent Establishments" (PwC, October 2015) <<https://www.pwc.co.uk/services/tax/insights/permanent-establishments.html>> accessed 20 October 2018

The research objective of this thesis is to identify the main PE risks faced by multinational enterprises at different stages of value chain, with a focus on distribution, and finally to suggest ways to address these risks to ensure tax compliance. The term “PE risk” in this paper refers to the risk of failure to comply with regulations on identifying taxable presence in the form of PE when certain business activities of the enterprise are held outside the country of its tax residency.

To reach this objective, this research paper should answer the following research questions:

1. What are the rationale and key features of permanent establishment concept under OECD Model Tax Convention on Income and on Capital (“OECD Model Tax Convention”), which is a model for countries concluding bilateral tax conventions?
2. What are the main principles of tax risk management and specific stages of managing PE-specific tax risks? How do they help MNEs to identify, analyse and mitigate PE risks in the enterprise?
3. How can MNEs (on the example of consumer electronics manufacturing industry) address the risk of dependent agent PE in the tax risk management framework?

The research model is restricted to identifying whether PE is present in certain business arrangements and planning tax control framework that would enhance timely PE identification in different business arrangements following the process starting from R&D of consumer electronics to its distribution to consumers. This research does not cover the detailed analysis of attribution of profits to PE⁷ or other procedural or dispute resolution aspects connected with identifying PE, nor the secondary effects of a PE, such as the impact of the PE status on income classification or determining tax withholding obligations of the employer.⁸ The primary source of analysis on the PE concept is the OECD Model Tax Convention. Other sources are referred to in order to support the general approaches of the OECD Model in interpreting the notion of PE, and to guide MNEs on what they should take into account when operating in multiple markets simultaneously. This thesis focuses on PE risks faced by multinational enterprise operating in the sphere of producing consumer electronics and their risks arising from employee mobility and transportation and distribution arrangements.

The novel contribution of this research project is in exploring the post-BEPS regulatory environment through legal methodology and risk management methodology. It provides MNEs

⁷ Article 7 of OECD Model Tax Convention states that “profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State”.

⁸ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 10

with an understandable and practically oriented guidance on reading the provisions of OECD Model Tax Convention and then implementing concrete steps to ensure compliance with them. It also incorporates a diversity of opinions from the business/industry sector, tax consulting sector, and academia on existing taxation regimes of PE.

This thesis consists of three chapters covering PE concept, its tax risk management and case study on dependent agent PE risk management in consumer electronics industry. The first chapter of the thesis focuses on exploring the general concept of PE, its role in international taxation, and the scope of its application. This allows us to understand the rationale of the PE concept and the general trend of its development in soft law and binding legislative norms as well as the main sources of legal uncertainty surrounding the PE concept. The second chapter concentrates on the analysis of tax risk management frameworks and how they help to deal with PE risks at different stages of tax risk management. This analysis is based on the key risk features of the PE concept identified in the first chapter and provides a systemic approach for assessing, prioritising, and treating PE risks. Chapter three provides an example of the practical application of PE tax risk management steps in addressing dependent agent PE risk under changes to Article 5 of OECD Model Tax Convention (BEPS Action 7). The structure of the thesis aims to gradually acquaint the reader with the challenges of interpreting the general PE concept and using risk management frameworks for dealing with it before moving to a deeper analysis of a dependent agent PE as one of the types of PE. This will allow the reader to see how legal research can be applied practically by sharing systematised knowledge among functions of an MNE. It also makes knowledge management a necessary component of tax controls framework and tax governance in general.

1.3. Methodology

Research of complex PE concept requires usage multiple methods that will allow to explore practical implications of applying a legal fiction (PE as a “fixed place of business”) to dynamic and versatile business arrangements. To map PE risks, it is important to identify and analyse key compound elements of PE concept under Article 5 of OECD Model Tax Provision, also through the prism general concepts of law (“person”, “agent”, “in the name of”). For this reason, the primary method of research is legal method. In this research, legal method will include comparative legal method used in analysing specifics of agency relationship in common and civil law countries (chapter 3). To understand the rationale behind OECD Model Tax Convention provisions on PE, teleological method is used to analyse the goals and principles of regulation of

international taxation in general⁹, and of PE concept in specific. In addition to that, descriptive method is used to analyse the common business arrangements in the value chain of the MNE before exploring its PE risks. Analytical method is a primary method to identify PE risk management strategies in chapter 2 and testing its application in chapter 3. My recommendations on risk treatment stages are also based on observational research method due to my practical experience in tax consulting and in developing internal controls framework.

1.4. Literature review

There is growing research on the substantial provisions of Article 5 of OECD Model Tax Provision. The starting point for PE research is Skaar's "Permanent Establishment: Erosion of a Tax Treaty Principle" (1991) that has created a basis for a critical research of PE concepts, elements and role in taxation. More recent research is represented by works of M.Lang, H. Pijl, E. Reimer, M. Kobetsky, J.-F. Dutriez, J. Schwarz. However, analysis of most recent post-BEPS changes from the perspective of business, not of a legislator or tax authorities, is addressed most in publication of Big Four companies and the smaller tax consulting companies. Namely, publications collected in "Dependent Agents as Permanent Establishments" (ed. M. Lang) provide a detailed analysis of history of dependent agent PE concept but do not cover post-BEPS reality as it was published in 2014. Most recent academic publications either address challenges of PE in digital economy on general level, or look into highly detailed aspects of PE, such as PE risks in certain warehousing activities. It shows the lack of conceptual analysis of changes brought by OECD Model Tax Convention 2017 and implications it will have for tax functions of MNEs.

When it comes to tax risk management side of PE analysis, the research focuses almost exclusively on tax risk management performed by tax authorities. Its deliverables are practical guidance for tax authorities, such as Risk Management Guide for Tax Administrations published by European Commission¹⁰ HMRC Internal Manual on Tax Compliance Risk Management¹¹, Australian Tax Office Tax Risk Management and Governance Review Guide.¹² However, practical steps on ensuring tax compliance from a taxpayer's perspective are rarely anywhere, except for publications of audit and consulting companies that create demand for tax risk

⁹ Vienna Convention of the Law of Treaties 1969, Article 31(1).

¹⁰ European Commission Fiscalis Risk Analysis Project Group, *Risk Management Guide for Tax Administrations* (2006)

<https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/tax_cooperation/gen_overview/risk_management_guide_for_tax_administrations_en.pdf> accessed 20 October 2018

¹¹ HM Revenue & Customs, *Tax Compliance Risk Management* (12 April 2016, updated 13 March 2017) <<https://www.gov.uk/hmrc-internal-manuals/tax-compliance-risk-management>> accessed 20 October 2018

¹² Australian Government Australian Taxation Office, *Tax risk management and governance review guide* (18 April 2018) <<https://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Tax-risk-management-and-governance-review-guide/>> accessed 20 October 2018

management consulting services. In second and third chapters of thesis, I will analyse how enterprises can apply the same risk management methodology as tax administrations, first on the example of general PE risk management and then by addressing dependent agent PE risk specifically.

Even though materials of consulting and auditing companies (primarily, Big Four accounting firms – EY, Deloitte, KPMG, PwC) do not represent the academic research, I cover their findings on PE tax risk management in detail for a couple of reasons. First, their research and scope of the services they offer set the trend and demand for services of tax risk management around the world. Second, findings of the external audit they conduct have a direct effect on the company, and thus, can have a significant preventative effect regarding tax avoidance. Third, “Big Four” and tax consulting companies regularly explore opinions of companies on managing tax risks in different jurisdictions and industries, and thus, provide most up-to-date information insights on how MNEs reach tax compliance goals.

Due to confidentiality of the tax function, my research is theoretical, and does not include any practical review of internal documentation of companies. Instead, I am exploring the tax strategy documentation of Electrolux at the stage of researching tax risk management framework in chapter 2. There are a couple of reasons for choosing Electrolux as a target company for practical examples. First, it is a consumer electronics company with headquarters in Stockholm, Sweden, which allows to analyse it under the umbrella of the EU law concepts and Nordic law. Second, it is known for its high level of corporate social responsibility: as of September 2018, it retained a leading position in Dow Jones Sustainability Indices.¹³ Third, its corporate communications materials provide detailed insights on goals and principles of tax risk management in the company, as well as structure of its internal controls.

¹³ Electrolux Group, “Electrolux retains position as industry leader in Dow Jones Sustainability Indices” (13 September 2018) <<https://www.electroluxgroup.com/en/electrolux-retains-position-as-industry-leader-in-dow-jones-sustainability-indices-26095/>> accessed 20 October 2018

2. PERMANENT ESTABLISHMENT CONCEPT IN INTERNATIONAL TAXATION

2.1. Introduction

The goal of this chapter is to look into concept of permanent establishment under OECD Model Tax Convention and explore how it is further interpreted in regulatory sources (on the example of Finland). This introductory overview will help to define main elements of PE concepts, its sources and current trends of its development, especially challenges imposed by digitalisation and globalisation. This will create a solid basis for mapping tax risks arising from PE arrangements (chapter 2) and case analysis of distribution arrangement (chapter 3).

First, I will start with analysis of sources that define PE at international and national levels. Then, I will identify the “global” concept of PE and its main elements. Next, I will look under changes to PE concept brought by BEPS Action 7. Finally, I will give concrete examples on interpretation of PE concept on the example of the Finnish law.

2.2. Background of PE regulation

PE is one of the most extensively analysed and constantly developing international tax concepts. Goal of PE can be summed up to allocating taxing rights between states and providing a threshold to exercise substantive jurisdiction.¹⁴ It is sometimes also called “the nexus rule” as it allows to determine jurisdiction to tax a non-resident enterprise when it carries activities in the other state (source state) through PE.¹⁵ This way, it ensures a compromise between residence-state taxation and source-state taxation.¹⁶

“Concept of PE is still as valuable as it was more than 100 years ago”¹⁷ – this statement shows the long history of PE and non-decreasing importance of this concept. First attempts to regulate PE go back to the late 1800s, in the tax treaty between Austria-Hungary and Prussia¹⁸, as a way to react to growing interaction between the Central European

¹⁴ Karoline Spies, “Permanent Establishment versus Fixed Establishment: The Same or Different?” [2017] 71(12) *Bullet for International Taxation* 706

¹⁵ OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project* (OECD Publishing, 2018) 168
<<https://doi.org/10.1787/9789264293083-en>> accessed 20 October 2018

¹⁶ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 31

¹⁷ Chris Finnerty et al, *Fundamentals of International Tax Planning* (IFBD, 2007) 48

¹⁸ Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (Cambridge U. Press 2011) 109

countries¹⁹ and economic development trends of industrial evolution era.²⁰ It appears almost since the first tax treaties in the beginning of the 20th century, at that time becoming equal to physical presence requirement.²¹ After the First World War, cross-border activities began to grow, as well as willingness of tax authorities to tax such transactions. This led the League of Nations to start developing PE concept in late 1920s to avoid impediments for trading relationships.²² At that time, PE was defined as a list of examples of situations or business models that gave rise to taxation rights for the source state, namely “the real centres of management, affiliated companies, branches, factories, agencies, warehouses, offices, depots”.²³ These lists aimed to ensure source principle of taxation when jurisdiction to tax is based on the economic connection of an item of income to a country.²⁴ In 1956 the Organization for European Economic Co-operation (OEEC) issued the first report to clarify PE concept.²⁵ In 1950s, PE was already defined on a more general level as “a fixed place of business in one of the territories in which the business of the enterprise is wholly or partly carried on”.²⁶ Back then, the pillars of modern PE concept were framed in two mutually reinforcing movements, namely the definition of PEs and the attribution of profits to them.²⁷ Goals of promoting international commerce and reaching administrative simplicity further limited the rights of source countries and facilitated fragmentation of activities to avoid having a taxable presence.²⁸

Analysis of history of PE concept development allows to understand one of its key challenges in the 21st century. Namely, PE concept was created and developed as a

¹⁹ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 15

²⁰ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 65

²¹ Vishesh Dhuldhoya, “The Future of the Permanent Establishment Concept” [2018] 72 (4a) *Bulletin for International Taxation IBFD* (accessed 5 March 2018)

²² Lara Friedlander and Scott Wilkie, “Policy Forum – The history of tax Treaty Provisions and why it is important to know about it” [2006] 54 (4) *Canadian Tax Journal* 909

²³ Raffaele Petruzzi, “The Dependent Agent Permanent Establishment as an Extension of the Permanent Establishment Concept of Article 5(1) of the OECD Model Convention” 35 in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014)

²⁴ Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (Cambridge University Press, 2011) 29

²⁵ Raffaele Petruzzi, “The Dependent Agent Permanent Establishment as an Extension of the Permanent Establishment Concept of Article 5(1) of the OECD Model Convention” 35 in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014)

²⁶ Raffaele Petruzzi, “The Dependent Agent Permanent Establishment as an Extension of the Permanent Establishment Concept of Article 5(1) of the OECD Model Convention” 35 in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014)

²⁷ Adolfo Martín Jiménez, Preventing the Artificial Avoidance of PE Status (United Nations, September 2014) 21 <http://www.un.org/esa/ffd/tax/2014TBP2/Paper_PE_Status.pdf> accessed 20 October 2018

²⁸ Adolfo Martín Jiménez, Preventing the Artificial Avoidance of PE Status (United Nations, September 2014) 21 <http://www.un.org/esa/ffd/tax/2014TBP2/Paper_PE_Status.pdf> accessed 20 October 2018

legislative reaction to industrial revolution and therefore emphasises permanence and physically located business sites.²⁹ Even though the scope of PE taxation was gradually narrowed down to the detriment of source country,³⁰ later discussion will show that this trend is not as simple to evaluate as it may seem. Namely, digitalisation erodes the basic idea of PE as a physically fixed place, and at the same time, globalisation allows enterprises to become more skilful in implementing cross-border tax planning arrangements. Also, history analysis allows to identify the internal conflict of PE role in ensuring tax revenue and at the same supporting cross-border trade.

Definition of PE differs country to country. However, there are certain sources that allow to define main criteria of PE at the international level. Notion of stability of the taxpayer's activities is a key to interpret PE concept as it justifies taxing in the source country on the profits attributed to such activities.³¹ In other words, the home state will prevail, unless the taxpayer has a permanent establishment in the host state.³² However, for MNE entering the new markets, understanding the basic idea of PE concept is not enough. In other words, MNE needs to clearly comprehend the hierarchy of sources of hard and soft law defining PE concept, be able to define which source applies and which trends define its application. For these reasons, I will proceed with overview of PE concept sources and its main principles and explore the complex interplay between role of double taxation agreements and domestic law in defining PE threshold.

2.3. Sources of PE regulation

The starting point for analysis is Model Tax Convention on Income and on Capital (further referred to as “OECD Model Tax Convention” or “OECD Model”). OECD Model is the basis for countries to negotiate and apply bilateral tax treaties (more than 3,000 already³³) between countries, assist business and at the same time help to prevent tax evasion and avoidance.³⁴ The 2017 edition of the OECD Model is a result of consolidation of the

²⁹ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 70

³⁰ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 101

³¹ Esther Villa, “Multinational groups and permanent establishment issues” [2006] 7(2) *Business Law International* 184

³² Esther Villa, “Multinational groups and permanent establishment issues” [2006] 7(2) *Business Law International* 184

³³ Tax treaties: update to OECD Model Tax Convention released (OECD, 18 December 2017) <<http://www.oecd.org/tax/treaties/tax-treaties-2017-update-to-oecd-model-tax-convention-released.htm>> accessed 27 October 2018

³⁴ OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (OECD Publishing, 2017) <https://doi.org/10.1787/mtc_cond-2017-en> accessed 20 October 2018

treaty-related measures under OECD/G20 BEPS Project that exploited loopholes in tax rules to artificially shift profits to tax heavens.³⁵ The OECD Commentary of the Model Tax Convention (Model Tax Convention on Income and on Capital), further referred to as the OECD Commentary, OECD Report on the Attribution of Profits to Permanent Establishments, 2008 and 2010; OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010; and supplementary BEPS report are the starting point to define concept of PE.³⁶ The income of a PE can be allocated according to the OECD Report on The Attribution of Profits to Permanent Establishments of 2010.

Double taxation agreements (DTAs) in its turn provide case-by-case interpretation of PE concept implemented in international taxation situations (see Chart 1). It is ultimately important to clearly define and understand this concept to guarantee that source states do not lose revenue that otherwise they could have collected, if DTA did not exist.³⁷ DTAs fall under the scope of Vienna Convention of the Law of Treaties which imposes good-faith requirement (Article 31(1)) on interpretation of treaty terms in the range of reasonably foreseeable meanings. However, MNEs should be prepared for deviations due to linguistic peculiarities, wording of PE definition (especially when DTAs are drafted in several languages) and practice of its application.³⁸ It is important to remember that PE principle interpretation reflects the political views prevalent in international community.³⁹ Developing countries have additional goals when negotiating and signing DTAs. They aim to provide foreign investors with security regarding taxation regime, not only relief from double taxation.⁴⁰ All in all, content of DTA's is significantly influenced by language, peculiarities of legal system and case law, political and economic goals of the state in question.

³⁵ Base erosion and profit shifting (OECD, 2018) <<http://www.oecd.org/tax/beps/>> accessed 20 October 2018

³⁶ General Guidelines for the Attribution of Income to Permanent Establishment (VERO, 30 April 2018) <<https://www.vero.fi/en/detailed-guidance/guidance/59583/general-guidelines-for-the-attribution-of-income-to-permanent-establishment2/>> accessed 10 October 2018, further referred to as “**General Guidelines for the Attribution of Income to Permanent Establishment 2018**”

³⁷ Luis M. Almeida and Perrine Toledano, Understanding how the various definitions of Permanent Establishment can limit the taxation ability of resource- rich source countries (CCSI Briefing Note, March 2018) 5 <<http://ccsi.columbia.edu/files/2018/03/Optimizing-the-PE-clause-for-resource-riche-source-state-CCSI-2018-2.pdf>> accessed 20 October 2018

³⁸ Reimer, Ekkehart, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (5th edn*, Kluwer Law International, 2016) OECD MC-15.

³⁹ Arvid Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle (Kluwer Law International, 1991) 13

⁴⁰ Lee-Ann Steenkamp, "The permanent establishment concept in double tax agreements between developed and developing countries: Canada/South Africa as a case in point." [2014] 13(3) The International Business & Economics Research Journal 539 citing Eric Neumayer, "Do double taxation treaties increase foreign direct investment to developing countries?" [2007] 43(8) The Journal of Development Studies 1503

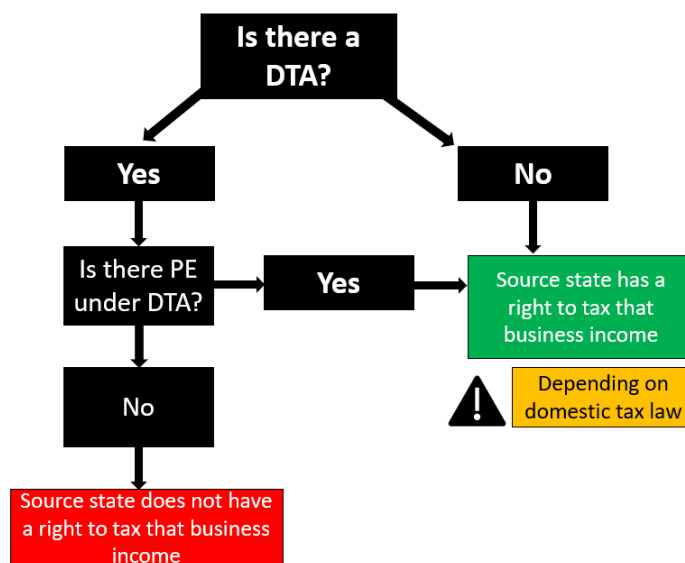


Chart 1. Application of double taxation agreements⁴¹

When there is no bilateral treaty between home and source states, domestic law provisions will define whether PE exists. Only in cases when all attempts to interpret PE concept based on language or context of DTAs have failed, one may revert to domestic law.⁴² Jurisdictions may take either quantitative (focus on the extent of activities, turnover, number of transactions, duration) or qualitative (focus on commercial nature of activity) approach to assessing presence of PE.⁴³ In some countries, OECD definition of PE is incorporated in domestic legislation, but domestic laws frequently are more onerous than a DTA definition of a PE might be, under equivalent economic circumstances, as business community notes.⁴⁴ OECD Member countries considerably vary in domestic tax law provisions on PEs.⁴⁵ Noticeable deviations include definitions of service PEs, adding further examples in the list of possible PEs and differences in interpreting what constitutes

⁴¹ Luis M. Almeida and Perrine Toledano, Understanding how the various definitions of Permanent Establishment can limit the taxation ability of resource- rich source countries (CCSI Briefing Note, March 2018) 5 <<http://ccsi.columbia.edu/files/2018/03/Optimizing-the-PE-clause-for-resource-riche-source-state-CCSI-2018-2.pdf>> accessed 20 October 2018

⁴² Ekkehart Reimer, Stefan Schmid, and Marianne Orell, Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (5th edn, Kluwer Law International, 2016) OECD MC – 6

⁴³ Arvid Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle (Kluwer Law International, 1991) 276

⁴⁴ Fuad S. Saba, “Permanent Establishment Risk in the Global Mobility Context” (Global Tax Network, July 2014) <<https://www.gtn.com/newsletter-2014-07.php>> accessed 20 October 2018

⁴⁵ OECD Directorate for Financial, Fiscal and Enterprise Affairs, Committee on Fiscal Affairs, *Discussion Draft on the Attribution of Profits to permanent Establishments DAF/FE/CFA(2001)28/CONF* (OECD, 2001) 4 <<https://www-oecd-ilibrary-org.libproxy.helsinki.fi/docserver/9789264184527-en.pdf?expires=1537903768&id=id&accname=ocid194948&checksum=467C7F57420C8FE5F6A3322C2AB15AB8>> accessed 20 October 2018

preparatory or auxiliary activities.⁴⁶ Also, states may define activities that constitute two or more PEs under tax treaty as just one PE under applicable domestic law.⁴⁷ It shows that MNE should take into account not only literal wording of PE concept but also the theory, history and politics behind PE concept in the state where it is functioning. Later in this chapter, I will explore domestic law sources of PE regulation in more detail on the example of Finland.

Analysis of sources of PE concept regulation shows that we can consider OECD Model Tax Convention as a starting point for defining PE concept, as it will allow to map us possible points of discrepancies in state-specific application. However, before I turn to current definition, I would like to start with analysis of principles of international taxation that define both the approach to PE concept and direction in which it evolves.

2.4. Principles and goals in regulation of international taxation

The overarching reason for introduction of PE concept is “the avoidance of double taxation in order to reduce tax obstacles to cross-border services, trade and investment”. It means that existing double taxation risks is the primary tax policy concern.⁴⁸ Main part of OECD Model defines extent of income taxation by each of two Contracting States and ways to eliminate international juridical double taxation.⁴⁹

Certain tax policy considerations and principles have historically defined evolution of taxation systems, namely:⁵⁰

- Neutrality: “Taxation should seek to be neutral and equitable between forms of business activities.”
- Efficiency: minimisation of compliance costs.
- Certainty and simplicity: clear and simple to understand tax rules, as complexity favours aggressive tax planning.

⁴⁶ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD-MC7-8

⁴⁷ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD-MC7-8

⁴⁸ OECD, *Model Tax Convention on Income and on Capital: Condensed Version 2017* (OECD Publishing, 2017) 13 https://doi.org/10.1787/mtc_cond-2017-en, accessed 20 October 2018, further referred to as **2017 OECD Model Tax Convention on Income and on Capital**

⁴⁹ 2017 OECD Model Tax Convention on Income and on Capital 15

⁵⁰ OECD, “Fundamental principles of taxation”, in *Addressing the Tax Challenges of the Digital Economy* (OECD Publishing, 2014) 30 <<https://doi.org/10.1787/9789264218789-5-en>> accessed 20 October 2018

- Flexibility: dynamic taxation systems keeping pace with technological and commercial developments.
- Equity: horizontal equity meaning that taxpayers in similar circumstances have a similar tax burden, vertical equity meaning variation of taxation regime based on volume of income, and inter-nation equity, aiming to guarantee each country an equitable tax revenue share from cross-border transactions.⁵¹

These principles are strongly based on goals of OECD – enhancing tax transparency, addressing tax avoidance, promoting tax policies for strong, sustainable and inclusive growth, supporting tax as a tool for development.⁵² The lack of clarity would discourage MNEs from engaging in countries with unclear taxation rules and will therefore discourage and delay foreign investment.⁵³ Also practicability is a guiding principle and a benchmark for interpreting treaty terms.⁵⁴ OECD members state that simplicity, administrability and sound tax policy are their primary goals.⁵⁵

In continuation of OECD Model goals, PE concept serves three main goals. First, it is a part of a broader picture of ensuring international justice in assigning substantial profits to the respective source state.⁵⁶ Second, it ensures neutrality between the different forms of establishments that foreign investors can choose as PE concept puts foreign investors at an equal footing with a local entrepreneur.⁵⁷ Third, PE concept aims at minimising unneeded compliance and administration costs of auditing entities that are not present in a respective state.⁵⁸ All in all, main objective of PE is to reconcile interests of international justice and practical feasibility to simplify cross-border taxation. Understanding underlying principles

⁵¹ OECD, "Fundamental principles of taxation", in *Addressing the Tax Challenges of the Digital Economy* (OECD Publishing, 2014) 30-31 <<https://doi.org/10.1787/9789264218789-5-en>> accessed 20 October 2018

⁵² OECD Work on Taxation (OECD Centre for Tax Policy and Administration, 2018) 7-8 <<https://www.oecd.org/tax/centre-for-tax-policy-and-administration-brochure.pdf>> accessed 20 October 2018

⁵³ BIAC response to the OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment) (BIAC, 31 January 2013) 5 <<http://www.oecd.org/ctp/treaties/PERMESTBIAC.pdf>> accessed 9 November 2018

⁵⁴ Reimer, Ekkehart, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC - 87

⁵⁵ Robert Feischreiber, and Margaret Kent, "Attribution of Profits to a Permanent Establishment" [2000] 2 *Corporate Business Taxation Monthly* 15

⁵⁶ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC-11

⁵⁷ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC-12

⁵⁸ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC-12

helps us to comprehend how these goals can be achieved and what changes to legislation we can expect.

Any failure to correctly address rapidly evolving business arrangements under PE model can lead to following situations:

- (i) minimal taxation (if taxable income resides in a low-tax jurisdiction);
- (ii) double non-taxation of profits (if the domestic law treaties of the source and residence countries do not cover this situation), which could be considered treaty abuse; or
- (iii) double taxation (worldwide taxation in one country and source taxation in the other).⁵⁹

Analysing principles of PE concept regulation and consequences of establishing an ineffective PE threshold shows how important it is for international community to regulate PE taxation coherently, and for MNEs to keep up with the regulatory trends. OECD Model Tax Convention sets the general standard how states define PE in tax treaties and domestic law,⁶⁰ so I will focus on how it sets PE threshold.

2.5. PE concept under OECD Model Tax Convention

I have explored the significant role of OECD Model Tax Convention that sets the goals, principles and mechanisms of international taxation. I will address the wording of OECD Model together with positions provided in OECD Commentary, as both these documents have a status of OECD Recommendations – soft law obligations imposed by OECD on its Member States.⁶¹

Under Article 5 of OECD Model Tax Convention on Income and on Capital, permanent establishment is defined as “a fixed place of business through which the business of enterprise is wholly or partly carried on”.⁶² Main role of PE concept is “to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting

⁵⁹Jean-François Dutriez, “*Attribution of Profits to a Permanent Establishment of a Company Engaged in Online Sales of Goods through a Local Warehouse*” [2018] 25(3) International Transfer Pricing Journal 185

⁶⁰ Model Tax Convention on Income and on Capital: Condensed Version 2017 (OECD, 18 December 2017) <<http://www.oecd.org/ctp/treaties/model-tax-convention-on-income-and-on-capital-condensed-version-201745419.htm>> accessed 10 November 2018

⁶¹ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC – 20

⁶² 2017 OECD Model Tax Convention on Income and on Capital 30

⁶³ See Annex 1 for detailed wording and structure breakdown.

State”, as Article 7a of OECD Model prevents a Contracting State from taxing the profits of an enterprise of the other Contracting State unless it carries on its business through PE established therein.⁶⁴ In other words, PE creates taxable presence for purposes of corporate income taxation (“CIT”). The language in Article 5(1) suggests that there is a PE when objective criteria are satisfied, leaving no room for taxpayer choice.⁶⁵ By this definition, OECD Model creates a legal fiction (an assertion for regulatory purposes) of PE as a “separate and independent enterprise” or of a “distinct and separate enterprise.”⁶⁶ It indicates a particular level of business activity in the Source State, starting from archetypal “physical” PE.⁶⁷ PE is not a legal entity in the source state, but is an “extension” of an entity legally existing in the residence (home) state.⁶⁸

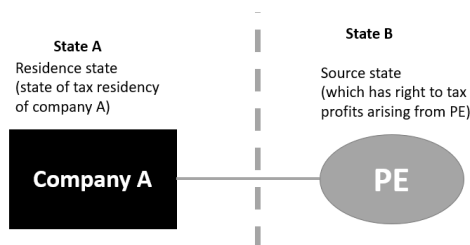


Chart 2. PE concept

When analysing PE concept, general questions that MNE should answer when planning activities abroad and that are answered by OECD Model Tax Convention, are:

- What is a fixed place of business?
- Whose place of business?
- What constitutes a dependent agent and what scope of its activities fall under PE?

⁶⁴ 2017 OECD Model Tax Convention on Income and on Capital 116

⁶⁵ Clifton Fleming, “A Note on the Zimmer Case and the Concept of Permanent Establishment” [2011] Tax Treaty Case Law around the Globe 109 SSRN <<https://ssrn.com/abstract=2079317>> accessed 20 October 2018

⁶⁶ Charles Lincoln, “Approaches to Attribution of Profits in International Corporate Permanent Establishments’ Taxable Separate Entities” [2017] 22(30) Trinity Law review SSRN 2 <<https://ssrn.com/abstract=2919387>> accessed 20 October 2018

⁶⁷ Leonardo Castro, “Problems Involving Permanent Establishments: Overview of Relevant Issues in Today’s International Economy.” [2011] 2 Global Business Law Review 126-127

⁶⁸ Jean-François Dutriez, “Attribution of Profits to a Permanent Establishment of a Company Engaged in Online Sales of Goods through a Local Warehouse” [2018] 25(3) International Transfer Pricing Journal 186

- What attention should be given to inconsistent use of clauses in a bilateral and multilateral treaties?⁶⁹

Under Article 5 Commentary, PE definition consists of following conditions:

1. Existence of a **“place of business”**. Under Article 5, it is any premises, facilities or installations at the factual disposal of the enterprise used to carry on business. Any substantial, physical object (including parts of the enterprise) which is commercially suitable to be a basis for a business activity will fall under “place of business”.⁷⁰ “Place” can be any location, constituting a coherent unit both in commercial and geographical senses in relation to a particular business.⁷¹ Under tradition approach, “place” means one or more tangible assets used to carry business, and cannot include exclusively a bunch of intangible assets, such as an internet site.⁷² The need for a geographical link (“location test”⁷³) and a certain duration are important elements of PE concept, but their actual application is flexible and sometimes inconsistent.⁷⁴ In practice, digital economy development challenges the traditional concept of “place” as will be discussed further. Term “business” allows to exclude passive investments from PE concept scope, as well as active income received on an occasional and low-scale basis.⁷⁵ One may get confused by misleading terminological difference between “enterprise” and “business”. Even though “enterprise” may refer to legal entity as institution and its status and “business” means concrete activities performed by the enterprise and its employees, this distinction is not consistent.⁷⁶ In such situation, taxpayer should be ready to refer to DTAs, domestic law and case law for a sufficient level of detail. The concept of “place of business” as shown in 2.2., emerged historically at the time of industrial revolution and is now challenged by

⁶⁹ Craig Elliffe, “Meaning of ‘Permanent Establishment’ in Article 5 of Double Tax Conventions” [2010] 16(1) New Zealand Journal of Taxation Law and Policy SSRN <<https://ssrn.com/abstract=1625603>> accessed 20 October 2018

⁷⁰ Arvid Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle (Kluwer Law International, 1991) 123

⁷¹ OECD, 2002 *Reports Related to the OECD Model Tax Convention*, Issues in International Taxation, No. 8 (OECD Publishing, 2002) 77 <<https://doi-org.libproxy.helsinki.fi/10.1787/9789264099920-en>> accessed 20 October 2018

⁷² Ekkehart Reimer, Stefan Schmid, and Marianne Orell, Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (5th edn, Kluwer Law International, 2016) OECD MC-37-38

⁷³ Arvid Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle (Kluwer Law International, 1991) 151

⁷⁴ OECD, 2002 *Reports Related to the OECD Model Tax Convention*, Issues in International Taxation, No. 8 (OECD Publishing, 2002) 76 <<https://doi-org.libproxy.helsinki.fi/10.1787/9789264099920-en>> accessed 20 October 2018

⁷⁵ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (5th edn, Kluwer Law International, 2016) OECD MC-40

⁷⁶ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective (5th edn, Kluwer Law International, 2016) OECD MC-40

globalisation and digitalisation trends, as further discussion will show. However, it remains the starting criterion to define PE threshold, which MNEs should analyse with care, especially its temporal and locational aspects.

2. **“Fixed” nature** of the place of business. Business profits are taxed in the source state only when an enterprise reaches a certain degree of permanence (not purely temporary nature) at a fixed place, to which an enterprise has a link and where business activities have certain intensity.⁷⁷⁷⁸ “Fixed” reflects the strong link between the land and the taxing powers of the state in many distributive rules of OECD Model, in order to establish jurisdiction of the source state, simplify cross-border activities and empower source state tax authorities with control and audit powers.⁷⁹ In other words, goal of a “fixed place” concept is to provide certainty both for taxpayers and for tax authorities and at the same time to guarantee enforceability of tax liabilities.⁸⁰ A place of business may, however, amount to PE even when it exists only for a very short period of time just due to the short-term nature of activities in general.⁸¹ It shows that concept of “fixed” requires qualitative analysis by authorities, that are to define PE threshold on case-by-case basis, and may come to unpredictable conclusions.

3. **“At the disposal of enterprise”**. This condition is not explicit in OECD Model Tax Convention, but is stated and explained in its Commentary which elaborates on use of “through” wording of OECD Model.⁸²⁸³ This criterion implies both test of the control of taxpayer over deemed PE and functional integration of PE into the business model of the enterprise.⁸⁴ Either legal title or factual circumstances can constitute the basis for control.⁸⁵ Namely, mere fact of having a certain amount of space at its disposal for business activities is sufficient to constitute a place of business, even if the enterprise has no formal legal

⁷⁷ Harald Moshhammer and Michael Tumpel, Attribution of Profits to a Dependent Agent PE in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 243

⁷⁸ 2017 OECD Model Tax Convention on Income and on Capital 121 (Commentary to Article 5, Para 22)

⁷⁹ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC - 37

⁸⁰ Tobias Hagemann, “Attribution of Profits Derived Before or After the Existence of a Permanent Establishment under Tax Treaty Law” [2017] 10(29) *Journal of Management and Financial Sciences* 197

⁸¹ 2017 OECD Model Tax Convention on Income and on Capital 122 (Commentary to Article 5, Para 28)

⁸² Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC - 58

⁸³ Harald Moshhammer and Michael Tumpel, Attribution of Profits to a Dependent Agent PE in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 243

⁸⁴ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC -58, 62

⁸⁵ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC - 59

right to this space.⁸⁶ In general, the taxpayer will be deemed to have place of disposal at his disposal only when he can employ it at his discretion.⁸⁷

All in all, threshold for considering a certain arrangement to be “at the disposal of enterprise” is low, as it is based on factual business arrangements, that are difficult not to find in any cross-border operation. In practice, it also causes uncertainties. Namely, IFBD Research Staff point out that OECD explains the concept of the place being “at the disposal of the enterprise” through examples that cannot cover all the possible real-life example and thus do not replace the need to provide a definition of “at the disposal”.⁸⁸

4. **“Permanent”.** The term “permanent establishment” itself contains the fourth feature, permanence as temporal stability of business arrangement.⁸⁹ This concept is relative, and is assessed together with such factors as location of the activity and number of clients.⁹⁰ Some believe that OECD Model Tax Convention provides a rule of thumb, under which there is no PE when place of business was maintained for less than 6 months.⁹¹ In practice, when assessing “permanence” in relation to their business arrangements, taxpayers should be ready to face the case when DTAs do not contain any explicit time rules on what constitutes “permanency”.⁹² This makes the permanence criterium the most vague among those we analysed, creating a basis for unpredictable interpretation by legislators and tax authorities.

It is also important to highlight the role of causal connection in determining existence of PE. Only the economic connection, expressed through a causal link between a PE and the income, should be determining for allocation to a PE.⁹³ As the causation principle is independent from time restrictions, there is a question whether income is caused by a PE, respectively the activity carried on therein.⁹⁴ However, causal connection is more

⁸⁶ 2017 OECD Model Tax Convention on Income and on Capital 118 (Commentary to Article 5, Para 11)

⁸⁷ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC - 60

⁸⁸ Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention (IFBD, 2012) 4 <<http://www.oecd.org/tax/treaties/49782184.pdf>> accessed 9 November 2018

⁸⁹ Ekkehart Reimer, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC-50

⁹⁰ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 226

⁹¹ Chris Finnerty et al, *Fundamentals of International Tax Planning* (IFBD, 2007) 40

⁹² Reimer, Ekkehart, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC -51

⁹³ Tobias Hagemann, “Attribution of Profits Derived Before or After the Existence of a Permanent Establishment under Tax Treaty Law” [2017] 10(29) Journal of Management and Financial Sciences 205

⁹⁴ Tobias Hagemann, “Attribution of Profits Derived Before or After the Existence of a Permanent Establishment under Tax Treaty Law” [2017] 10(29) Journal of Management and Financial Sciences 205

important at the stage of profit attribution as it comprises procedural aspect of PE concept, which is outside the scope of this research.

Article 5 of OECD Model Tax Convention also defines following:

- Examples of PE (a place of management, a branch, an office, a workshop, or place of extraction of natural resources; building site or construction or installation project lasting more than 12 months). Namely, the list stated in Article 5(4) identifies four types of requirements: elements related to the primary activity (use and maintenance), location-related elements (facilities, stocks, fixed places of business), object-related elements (goods, information, merchandise) and elements describing intended activity (storage, display and delivery).⁹⁵
- List of preparatory or auxiliary arrangements that do not fall under PE scope, primarily based on purpose criteria (to combat international tax planning that erodes the sovereignty of the market country⁹⁶). For correct application of PE concept, it is vitally important to distinguish such activities from the core business activities.⁹⁷
- Dependent agent concept as a separate type of PE (further addressed in chapter 3 of the thesis on example of distribution models).

PE concept under Article 5 of OECD Model Tax Convention can be split into several types, based on nature of activities performed by PE and nature of relationship between company and its PE. Schwarz identifies two types of PE: physical PE and agency PE.⁹⁸ Consulting community proposes a more detailed classification of PE, which can provide MNEs with more detailed understanding whether their business arrangements or steps in value chain fall under scope of PE.⁹⁹¹⁰⁰

⁹⁵ Reimer, Ekkehart, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC - 89

⁹⁶ Peter Hongler and Pasquale Pistone, Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy (WU International Taxation Research Paper Series No. 2015 – 15) 12 SSRN <<https://ssrn.com/abstract=2591829>> accessed 20 October 2018

⁹⁷ Peter Hongler and Pasquale Pistone, Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy (WU International Taxation Research Paper Series No. 2015 – 15) 13 SSRN <<https://ssrn.com/abstract=2591829>> accessed 20 October 2018

⁹⁸ Jonathan Schwarz, *Schwarz on Tax Treaties* (2nd edn, Wolters Kluwer, 2011) 133

⁹⁹ For service PEs, see 2017 OECD Model Tax Convention on Income and On Capital 154-155 (Commentary to Article 5, Para 132)

¹⁰⁰ For construction PE classification, see also Raffaele Petrucci and Raphael Holzinger, “Profit Attribution to Dependent Agent Permanent Establishments in a post-BEPS era” [2017] 5 World Tax Journal 264

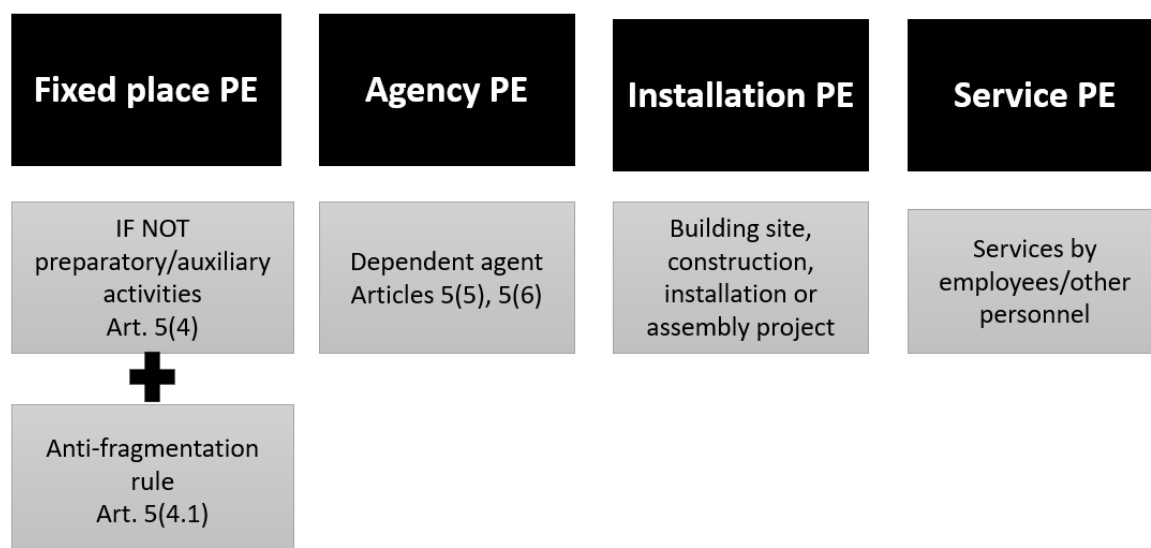


Chart 3. Practically oriented breakdown of PE definition under OECD Model Tax Convention¹⁰¹

Based on the public comments received on the 2017 draft update,¹⁰² an additional paragraph was added to separate PE treatment for profit taxation from the treatment of a foreign company for VAT/GST purposes, including from the cases when a foreign enterprise has registered for VAT/GST purposes.¹⁰³ However, this research focuses only on PE concept for income tax purposes.

Analysis of compound elements and types of PE allows us to structure observations on changes to PE concept, as well as identify risks that stem from incoherent interpretation of PE across jurisdictions. The main goal of explicit definition of PE is to provide certainty and simplicity (see 2.4). However, challenges in modern economy create the need to amend the definition of PE, and thus, put the legal certainty at risk. Most recent and notable case of PE concept reform are BEPS actions that will be analysed below.

2.6. Impact of BEPS Actions and MLI on PE concept

¹⁰¹ PwC, The Past, Present and Future of Permanent Establishment (September 2017) 9 <<https://www.pwc.in/assets/pdfs/publications/2017/the-past-present-and-future-of-permanent-establishment.pdf>> accessed 20 October 2018

¹⁰² Draft contents of the 2017 Update to the OECD Model Tax Convention: Comments received on the 11 July 2017 public release (OECD, 11 August 2017) 8 <<http://www.oecd.org/ctp/treaties/public-comments-on-draft-contents-2017-update-OECD-model.pdf>> accessed 10 November 2018

¹⁰³ OECD Council approves the 2017 update to the OECD Model Tax Convention (OECD, 23 November 2017) <<http://www.oecd.org/ctp/treaties/oecd-approves-2017-update-model-tax-convention.htm>> accessed 20 October 2018

“You can see BEPS as a set of rules, or you can see it as a milieu, a general change in the way tax is viewed,” business community notes.¹⁰⁴ BEPS action reflects the willingness of tax authorities to come up with a common approach to address new tax avoidance technologies that were enabled by globalisation and digitalisation. Namely, newer business models such as digital marketplaces, online catalogues and portals allow taxpayers to generate income in a country with minimal or no physical presence in that country.¹⁰⁵ These new challenges have opened up ways for MNEs to minimise their tax burdens and created the need for prompt action to prevent regulatory gaps.¹⁰⁶ The OECD/G20 countries adopted an Action Plan in 2013 as part of the BEPS Project.¹⁰⁷ It was the first time that all OECD and G20 countries united to design common responses to challenges of international taxation.¹⁰⁸ In October 2015, more than 12,000 pages of comments and 13 reports had been published.¹⁰⁹ This work resulted in publishing 15 actions to equip governments with domestic and international instruments to address tax avoidance.¹¹⁰ These instruments are aimed to enforce the core principle of BEPS initiative - “Taxation where value is created”.¹¹¹

BEPS Actions resulted in amending OECD Model Tax Convention and its interpretation. Namely, Article 5 of OECD Model Tax Convention and Commentary to it underwent a number of changes in 2017 to clarify interpretation of the Article, in light of Report on Action 7 of the OECD/G20 Base Erosion and Profit Shifting Project.¹¹² Goal of OECD was to update definition of permanent establishment (PE) to prevent abuses that allowed to

¹⁰⁴ Chris Wright, “BEPS in the boardroom: Cracking down on multinational tax avoidance” (CPA Australia, 1 February 2017) <<https://www.intheblack.com/articles/2017/02/01/beps-cracking-down-tax-avoidance>> accessed 20 October 2018

¹⁰⁵ Clinton Alley and Joanne Emery, “Avoidance of Permanent Establishment and Multilateral Modifications of Tax Treaties” [2017]11 Journal of International Taxation 41

¹⁰⁶ Jean-François Dutriez, “*Attribution of Profits to a Permanent Establishment of a Company Engaged in Online Sales of Goods through a Local Warehouse*” [2018] 25(3) International Transfer Pricing 187

¹⁰⁷ Closing tax gaps - OECD launches Action Plan on Base Erosion and Profit Shifting (OECD, 19 July 2013) <<http://www.oecd.org/tax/closing-tax-gaps-oecd-launches-action-plan-on-base-erosion-and-profit-shifting.htm>> accessed 20 October 2018

¹⁰⁸ OECD/G20 Base Erosion and Profit Shifting Project Explanatory Statement (OECD, 2015) 4 <<http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>> accessed 20 October 2018

¹⁰⁹ OECD, Top 10 FAQs about BEPS (OECD) <<https://www.oecd.org/ctp/top-10-frequently-asked-questions-about-beps.pdf>> accessed 20 October 2018

¹¹⁰ BEPS Actions (OECD) <<http://www.oecd.org/ctp/beps-actions.htm>> accessed 20 October 2018

¹¹¹ Johanna Hey, “Taxation Where Value is Created” and the OECD/G20 Base Erosion and Profit Shifting Initiative” [2018] 72 (4/5) Bulletin for International taxation 203

¹¹² Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report (OECD, 5 October 2015) 13 <<http://www.oecd.org/ctp/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm>> accessed 10 May 2018

avoid the tax nexus.¹¹³¹¹⁴ As a result, BEPS Action 7 has lowered PE threshold (conditions under which a business model will be considered PE) which is evident from following changes:

- adoption of a broader agency PE rule;¹¹⁵
- a narrower interpretation of the “preparatory and auxiliary” exception;¹¹⁶
- revision of dependent agent PE concept aimed to address the avoidance of Article 5 through "commissionaire arrangements";¹¹⁷
- the adoption of an anti-fragmentation rule¹¹⁸. Goal of this addition was to prevent enterprises to split their business activities in the same countries in smaller pieces to claim PE exceptions due to “preparatory or auxiliary nature” of such fragmented activities.¹¹⁹

Some believe that lowered threshold is predictable based on amendments made to the Commentaries on the OECD Model over the years. Such signals were the addition of the painter example, the incorporation of provisions in the OECD Commentary on e-commerce, arrival of the optional services PE clause and the OECD’s work on the Discussion Draft on PEs of 2012.¹²⁰ However, it is increasingly likely under article 5 of the OECD Model (2017) PE will be identified in cases where none would have been considered it before.¹²¹ Namely, changes brought by BEPS Actions introduce reference to

¹¹³ OECD/G20 Base Erosion and Profit Shifting Project Explanatory Statement (OECD, 2015) 8
<<http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>> accessed 20 October 2018

¹¹⁴ Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report (OECD, 5 October 2015) 13 < <http://www.oecd.org/ctp/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm>> accessed 10 May 2018

¹¹⁵ Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report (OECD, 2015) 15 <<https://www.oecd-ilibrary.org/docserver/9789264241220-en.pdf>> accessed 21 October 2015

¹¹⁶ Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report (OECD, 2015) 15 <<https://www.oecd-ilibrary.org/docserver/9789264241220-en.pdf>> accessed 21 October 2015

¹¹⁷ Clinton Alley and Joanne Emery, “Avoidance of Permanent Establishment and Multilateral Modifications of Tax Treaties” [2017] 11 Journal of International Taxation 38-49

¹¹⁸ BEPS Action 7 Additional Guidance on Attribution of Profits to Permanent Establishments (OECD, 22 June -15 September 2017) Para 40 < <https://www.oecd.org/tax/transfer-pricing/beps-discussion-draft-additional-guidance-attribution-of-profits-to-permanent-establishments.pdf>> accessed 20 October 2018

¹¹⁹ Permanent establishments: Recent trends and developments (EY, 2015) 22
<[https://www.ey.com/Publication/vwLUAssets/ey-permanent-establishments/\\$FILE/ey-permanent-establishments.pdf](https://www.ey.com/Publication/vwLUAssets/ey-permanent-establishments/$FILE/ey-permanent-establishments.pdf)> accessed 20 October 2018

¹²⁰ Vishesh Dhuldhoya, “The Future of the Permanent Establishment Concept” [2018] 72 (4a) Bulletin for International Taxation IBFD (accessed 5 March 2018)

¹²¹ Shee Boon Law , “Profit Attribution to Permanent Establishments – A Tax Treaty Perspective on the “Single Taxpayer” Approach” [2018] 72(3) Bulletin for International Taxation IFBD

different tax avoidance activities and business arrangements (e.g., “commissionaire agreements”) that are likely to receive incoherent interpretation based on specifics of legal systems and economic goals. Thus, these changes have a serious impact on legal certainty in the sphere of double taxation and should be addressed duly by MNEs. To support is interpretation of PE concept and simplify it in terms of PE procedural aspects, OECD have issued Additional Guidance on the Attribution of Profits to Permanent Establishments, BEPS Action 7 22 March 2018.¹²² I will analyse it further in the third chapter of thesis.

Finally, it is important to explore the actual stages to implement changes to OECD. In November 2016, over 100 states finalised negotiations on the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (“MLI”) that entered into force on 1st July 2018. Its goal is to swiftly implement a series of tax treaty measures to strengthen response of international tax rules to tax avoidance. Taxpayers should also take into account potential overlay of MLI with existing treaties and be ready to re-evaluate potential PEs in light of anti-fragmentation rule and principal purpose test (whether the primary goal of transaction was just to obtain the treaty benefit).¹²³

2.7. PE concept at supranational level: EU case

This research focuses on PE risk management for European MNEs functioning in telecommunications sector, meaning that they fall under the EU law. PE regulation on EU level is notably shaped by freedoms of the EU, namely freedom of establishment (case 07/16/1998, C-264-96, Imperial Chemical Industries—ICI).¹²⁴ The EU is facing same challenges as many other states outside the EU. Namely, digital businesses rely heavily on intangible goods, data transfers and automation that minimise the need of physical presence in the market country and actually allow to avoid physical presence.^{125 126} Inappropriateness of traditional PE for taxing threshold was exposed already in 1991 even

¹²² Additional Guidance on the Attribution of Profits to a Permanent Establishment under BEPS Action 7 (OECD, 22 March 2018) <<http://www.oecd.org/tax/beps/additional-guidance-attribution-of-profits-to-a-permanent-establishment-under-beps-action7.htm>> accessed 20 October 2018

¹²³ Manal Corwin, Practical Questions for Multinationals in an MLI World (Tax Executive, 20 November 2017) <<http://taxexecutive.org/practical-questions-for-multinationals-in-an-ml-world/>> accessed 20 October 2018

¹²⁴ Pietro Boria, Taxation in European Union (2nd edn, Springer, 2017) 107

¹²⁵ Ashish Goel and Shilpa Goel, “Has the Permanent Establishment Rule Outlived Its Utility in a Digitalized World?” [2018] 11(1) NUJS Law Review 3 SSRN <<https://ssrn.com/abstract=3202309>> accessed 20 October 2018

¹²⁶ Wolfgang Schön, “Ten Questions about Why and How to Tax the Digitalized Economy” [2018] 72 (4/5) Bulletin for International Taxation 278

before world faced true implications of digital revolution.¹²⁷ Now it is a hot question whether governments should reconsider this traditional concept of PE as physical presence or whether there is a need to come up with some other form of source taxation.¹²⁸

MNEs functioning in the digital economy era share specific features in their business approach: they rely significantly on information and communication technologies, focus on operating intellectual property assets and tend to aggregate value creation chain.¹²⁹ To keep up with changes to business models, the EU introduced a new nexus concept, under which taxing rights may be allocated based on fulfilment of certain quantitative conditions necessary to substantiate “a significant digital footprint”.¹³⁰ The EU Council stated that “an appropriate nexus in the form of a virtual permanent establishment which would take into account where value is created in the different business models of the digital economy, should be explored” (15175/17).¹³¹

The EU is also addressing hybrid PE in light of implementation of the BEPS package.¹³² Subsequently, the Group also agreed on “soft law” guidance on hybrid permanent establishment (PE) mismatches involving two EU Member States, when one of the states considers it PE, and another state finds it to be a PE.¹³³ However, there was almost no signs of implementation efforts by EU Member States, and as a result, the Council invited the Group to properly monitor implementation from 2016 onwards.¹³⁴

It shows that the legislative plans of the EU answers global trends to address base erosion and ensure efficient taxation of digitalised business. The EU has been slow in implementing measures at first, but now authorities are focusing on pushing

¹²⁷ Nataša Žunić Kovačević and Stjepan Gadžo, “Proposals for Reform of the Agency permanent Establishment Concept: Examination of BEPS Action” in Vinko Kandžija, Andrej Kumar, *Economic Integration, Competition and Cooperation* (CEMAFI International Association, 2011) 515 <https://bib.irb.hr/datoteka/835896.Zbornik_FINALE_final.pdf> accessed 20 October 2018

¹²⁸ Georg Kofler, Gunter Mayr and Christoph Schlager, “Taxation of the Digital Economy: “Quick Fixes” or Long-Term Solution?” [2017] 57(12) *European Taxation* 523-524

¹²⁹ Daniel Blum, “Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative – The Nexus Criterion Redefined? [2015] (69/7) *Bulletin for International Taxation* 315

¹³⁰ Raffaele Petrucci & Vasiliki Koukouloti, *The European Commission’s Proposal on Corporate Taxation and Significant Digital Presence: A Preliminary Assessment* [2018] 58(9) *European Taxation* 393

¹³¹ Council of the European Union, Responding to the challenges of taxation of profits of the digital economy – Council conclusions (5 December 2017) <<http://data.consilium.europa.eu/doc/document/ST-15445-2017-INIT/en/pdf>> accessed 20 October 2018

¹³² Vinod Kalloe, “EU Code of Conduct – From Reviewing Individual Tax Regimes to Developing Horizontal Policy: Cracking the Code in the BEPS Era” [2016] 56(5) *European Taxation* 183

¹³³ Vinod Kalloe, “EU Code of Conduct – From Reviewing Individual Tax Regimes to Developing Horizontal Policy: Cracking the Code in the BEPS Era” [2016] 56(5) *European Taxation* 187

¹³⁴ Vinod Kalloe, “EU Code of Conduct – From Reviewing Individual Tax Regimes to Developing Horizontal Policy: Cracking the Code in the BEPS Era” [2016] 56(5) *European Taxation* 187

implementation forward. For MNEs, it would mean increased interest of tax authorities to conduct risk assessment of enterprises and update taxation guidelines in line with the EU aspirations.

2.8. PE concept in national laws: Finland case

By bringing example of Finnish legislation, I would like to show how PE concept is practically implemented in national regulation and double taxation treaties of a certain state. This would allow me to map main risks that should be considered when planning PE strategy (addressed in the second chapter).

National legal rules on foreigners' tax liability are present in § 9, § 10 and § 13a, Income Tax Act (TVL), and in § 83, Act on Assessment Procedure (*laki verotusmenettelystä*, VML).¹³⁵ Namely, definition provided in § 13a of TVL, consists of two parts. First part gives a short definition of PE as a “separate place of business for the purpose of carrying out business activities permanently or where different arrangements are taken”.¹³⁶ Out of OECD Model criteria, this definition focuses only on two: “place of business” and “permanence”. This potentially means lower PE threshold rather than under OECD Model, as there is no requirement for place to be “fixed” (from temporary point of view) or “at the disposal of enterprise”). The second part of definition lists examples of PE without classifying these types or providing their key identifying features. In addition to multiple bilateral treaties, Finland is also a part to Nordic Tax Treaty, which Article 5 defines PE same as OECD Model Tax Convention.¹³⁷ The guidelines and case law do not lay down what period of time is sufficient to create permanence, so it is determined on a case-by-case basis.¹³⁸ In practice, carrying out or trade in Finland without a PE is difficult.¹³⁹ However, the official guidance on the PE concept of tax treaties is rather limited, it is

¹³⁵ Income taxation of foreign corporate entities (VERO,30 April 2018)< <https://www.vero.fi/en/detailed-guidance/guidance/47806/income-taxation-of-foreign-corporate-entities/>>_accessed 20 October 2018

¹³⁶ Translation by an author.

¹³⁷ Nordic Tax Treaty (Nordisk eTax) <<https://www.nordisketax.net/main.asp?url=/ntt.asp&c=sve&l=eng>> accessed 20 October 2018

¹³⁸ Kristiina Äimä, Joakim Frände and Kenneth Hellsten, “The relevance of the OECD and UN Model Conventions and their Commentaries for the interpretation of Finnish tax treaties” in Michael Lang (ed.), *The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties* (Cambridge University Press, 2012) 395 citing citing Marianne Malmgrén and Jaakko Sivonen, ‘Finland’, in IFA Cahiers de droit fiscal international, *Is There a Permanent Establishment?* (Rotterdam: International Fiscal Association 2009 289

¹³⁹ Kristiina Äimä, Joakim Frände and Kenneth Hellsten, “The relevance of the OECD and UN Model Conventions and their Commentaries for the interpretation of Finnish tax treaties” in Michael Lang (ed.), *The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties* (Cambridge University Press, 2012) 394 citing M. Malmgrén, Oikeushenkilön asuinvaltio verotuksessa ja yritysten kansainvälistyminen [Tax Residence of a Legal Entity and Expansion of Business Activities Abroad] (Edita, 2008) 541

provided only on a general level and is mostly based on the OECD Commentary.¹⁴⁰ As a result, PE research is focusing on analysing separate cases when certain business models were considered PE (see the table below) without systematising or interpreting their key features.

Table 1. Finnish legislation and case law on determining permanent establishment¹⁴¹

May constitute PE	May not constitute PE (if only single criterium is satisfied)
“computer operating as a server” “fixed ticket office” a person “making decision concerning the company per procuration” “board of directors” with “bookkeeping and auditing ... done in Finland” “task of taking orders” (agency PE)	“mere export” “business... through a mobile place of business, e.g. operating transportation with a truck or bus” “a mere bank account”

Article 5 of the Model Tax Treaty of the OECD is a standard that governs the definitions of a PE in the tax treaties with Finland. Finland has reserved a right to use previous version of paragraphs 5, 6 (meaning versions before the 2017 update of the OECD Model), and not to include paragraphs 4.1 and 8 in its conventions.¹⁴² Tax treaties may vary in how details of PE concept are defined. For Finland, § 13 a, Income Tax Act provides a key domestic law definition of PE.¹⁴³ Most of Finland’s tax treaties are based on the OECD Model Tax Convention, whereas tax treaties with developing countries may have certain elements from the United Nations Model Double Taxation Convention between Developed and Developing Countries.¹⁴⁴ The PE list may slightly differ in treaties.¹⁴⁵

¹⁴⁰ Kristiina Äimä, Joakim Frände and Kenneth Hellsten, “The relevance of the OECD and UN Model Conventions and their Commentaries for the interpretation of Finnish tax treaties” in Michael Lang (ed.), *The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties* (Cambridge University Press, 2012) 394 citing Marianne Malmgrén and Jaakko Sivonen, ‘Finland’, in IFA Cahiers de droit fiscal international, *Is There a Permanent Establishment?* (Rotterdam: International Fiscal Association 2009) 284-285

¹⁴¹ Marjaana Helminen, *Finnish International Taxation* (Unigrafia, 2016) 82-89

¹⁴² 2017 OECD Model Tax Convention on Income and On Capital 169 (Commentary to Article 5, Paras 213-214)

¹⁴³ Income taxation of foreign corporate entities (VERO, 30 April 2018) <<https://www.vero.fi/en/detailed-guidance/guidance/47806/income-taxation-of-foreign-corporate-entities/>> accessed 20 October 2018

¹⁴⁴ Kristiina Äimä, Joakim Frände and Kenneth Hellsten, “The relevance of the OECD and UN Model Conventions and their Commentaries for the interpretation of Finnish tax treaties” in Michael Lang (ed.), *The*

Tax control performed by the Finnish Tax Administration in relation to domestic and foreign corporate entities consists of assessment procedure, tax audits, taxpayer guidance, monitoring of tax payments and exchange of information between Finnish and foreign tax authorities.¹⁴⁶ Analysis has shown that Finnish legislation and case defines presence of PE on a case-by-case basis. For MNEs it would mean that their business arrangements would undergo qualitative analysis that may focus on unpredictable scope of factors. To ensure efficient cooperation with tax authorities, it is vital for MNEs to invest sufficient amount of time and resources into PE risk management.

2.9. Conclusions

Analysis of principles of international taxation regulation and main goals of OECD Model Tax Convention has highlighted the complex role of PE concept which is balancing between ensuring tax revenue for tax authorities and favourable tax regime for taxpayers without double taxation risk. Keeping this balance in practice, especially in light of challenges brought by business models of digital economy, is not an easy task for a legislator. Namely, OECD has reacted to digitalisation and globalisation by amending PE definition under BEPS Actions, which brought the legal uncertainty for MNEs, especially when different countries implement changes at different pace. It makes detailed awareness of PE concept vital for planning and performing operations cross-borders, as well as for effective cooperation with tax authorities.

In light of this, when a business is entering a foreign market, it should answer a few basic questions to estimate whether PE will be created:

Is there a tax treaty between the company's home country and the foreign jurisdiction? In case if treaty exists, the taxpayer should be ready to analyse the language and definitions that determine whether PE exists. If there is no treaty, the primary object of

Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties (Cambridge University Press, 2012) 387

¹⁴⁵ Kristiina Äimä, Joakim Frände and Kenneth Hellsten, "The relevance of the OECD and UN Model Conventions and their Commentaries for the interpretation of Finnish tax treaties" in Michael Lang (ed.), *The Impact of the OECD and UN Model Conventions on Bilateral Tax Treaties* (Cambridge University Press, 2012) 395

¹⁴⁶ Income taxation of foreign corporate entities (VERO, 30 April 2018) <<https://www.vero.fi/en/detailed-guidance/guidance/47806/income-taxation-of-foreign-corporate-entities/>> accessed 20 October 2018

the analysis will be domestic tax law which may be less favourable than OECD Model provisions.¹⁴⁷

What are type of activities of the business, its employees and third parties may trigger PE? What is the scope of the “fixed place of business definition” under applicable sources of PE concept? Answer to these questions will allow to estimate whether specific business arrangements and stages of value chain of enterprise will fall under PE. The broader the scope of “fixed place” definition is, the more likely it is that the business deals with low PE threshold, where, for instance, employee cross-border mobility may easily raise PE.¹⁴⁸

Is “permanence” test of PE created by continuous presence in the country in line with certain time threshold? In this aspect, the enterprise should be prepared for possible aggregate and complex models of calculating the presence in source country (e.g. in case of China).¹⁴⁹

Finding answers to these questions is not an easy task due to many reasons: ongoing changes to PE concepts, multitude of jurisdictions involved, as well as time and resource constraints faced by tax function. For this reason, it is important to identify risks of failing to identify PE existence in business arrangements, prioritise PE risks and address them promptly. In next chapter, I will look into how PE risk management, including building tax controls as a part of tax governance framework can help to structure corporate knowledge on cross-border PE taxation and ensure efficiency in reaching tax compliance and tax governance goals of MNE.

¹⁴⁷ Richard Lyons, “Creation Of Permanent Establishment: What multinationals need to know” (HR.com, 31 May 2016) < https://www.hr.com/en/topleaders/all_articles/creation-of-permanent-establishment-what-multinati_iowa6kqc.html > accessed 21 October 2018

¹⁴⁸ Richard Lyons, “Creation Of Permanent Establishment: What multinationals need to know” (HR.com, 31 May 2016) < https://www.hr.com/en/topleaders/all_articles/creation-of-permanent-establishment-what-multinati_iowa6kqc.html > accessed 21 October 2018

¹⁴⁹ Richard Lyons, “Creation Of Permanent Establishment: What multinationals need to know” (HR.com, 31 May 2016) < https://www.hr.com/en/topleaders/all_articles/creation-of-permanent-establishment-what-multinati_iowa6kqc.html > accessed 21 October 2018

3. ADDRESSING PE RISK THROUGH TAX RISK MANAGEMENT FRAMEWORK

3.1. Introduction

Analysis performed in chapter 1 has equipped with understanding of rationale of PE concept, its goals, compound elements and challenges to it brought by digitalisation and globalisation. This chapter will provide an overview of PE risk management focusing on consumer electronics industry. To be able to focus on PE risk management, it is important to first define concepts of tax compliance, tax governance and tax management. Then, I will identify stages of tax risk management and apply them for defining PE tax risk management procedures for MNEs performing cross-border business activities.

I analyse PE risk management framework on the example of telecommunications industry with the focus on consumer electronics. This allows to track how changes of digital economy and globalisation impacts the value chain of electronics production and distribution, as well as creates new challenges for enterprises to identify changing provisions of PE taxation regime.

3.2. Tax governance and tax compliance as basis for PE tax risk management

In this research, I focus on tax challenges presented by PE risk to telecommunications industry with focus on consumer electronics, such as home equipment, TV, radio systems and mobile phones. In such enterprises, value chain includes multiple jurisdictions, and ways of communicating with employees, customers and consumers are sufficiently digitalised. In addition to that, a global span of business activities means ambitions to enter new markets or try new business models, as well as involvement of multiple persons in functions that have impact on tax management planning.

There is a certain controversy in taxation of MNEs. National tax authorities, on the one hand, admit that telecommunications industry are important for growth, partially because of consumer welfare, but on the other hand, see them as a good source of revenues due to increasing turnover.¹⁵⁰ At the same time, tax authorities are challenge by keeping up with

¹⁵⁰ Thornton Mateson and Patrick Petit, “IMF Working Paper WP/17/247. Taxing Telecommunications in Developing Countries” (IMF, 2017) 4
<<https://www.imf.org/~media/Files/Publications/WP/2017/wp17247.ashx>> accessed 21 October 2018

changes in technology that blur the lines between several sectors, such as information services, enhanced services, and telecommunications.¹⁵¹

Based on this, we can identify three main challenges for telecommunications sector:

1. Taxation becomes a strategic concern with broader stakeholder focus.
2. Regulators become more demanding when it comes to transparency, board engagement and requirements to control systems to align conflicting interests in taxing telecommunications sector.
3. Organisations are transforming their commercial strategies, support functions and application of new technologies.¹⁵²

Taxation regulations that pose challenges for telecommunications companies are driven by the goal of identifying and preventing tax avoidance and aggressive tax planning strategies. Concepts of tax avoidance and tax planning which tax governance aims to prevent varies a lot between countries and depends on form of an arrangement, attitudes of courts, government, legislature and public opinion.¹⁵³ The new philosophy of transparent tax competition (that can even amount to a totally new “global tax order”¹⁵⁴) and cooperation between tax authorities and business should be reflected in a change of mentality, uniting good tax compliance with mechanisms to measure good corporate governance.¹⁵⁵ Increased need for ensuring and demonstrating tax compliance urges market players to align with multiple requirements, including robust documentation and transparency requirements, and alignment of functions across the value chain to address and mitigate tax, audit and reputational risk.¹⁵⁶ Thus, more enterprises become inherently cautious, dedicate more time to risk management, raise concerns about compliance risk and their

¹⁵¹ Jim Nason, “Tax Offerings for the Telecommunications Industry” (Deloitte, 2018) <<https://www2.deloitte.com/us/en/pages/tax/solutions/tax-services-telecommunications-industry.html>> accessed 21 October 2018

¹⁵² After Marvin de Ridder, Managing tax: Balancing current challenge with future promise (Deloitte, 30 November – 1 December 2016) 4 <<https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-tmc-emea-conference-2016-tax-risk-management-and-control.pdf>> accessed 21 October 2018

¹⁵³ Michael Kobetsky, *International Taxation of Permanent Establishments: Principles and Policy* (Cambridge University Press, 2011) 40

¹⁵⁴ See Joachim Lang and Joachim Englisch, “A European Legal Tax Order Based on Ability To Pay” in Andrea Amatucci (ed.), *International Tax Law* (Kluwer Law International, 2006) 251-255

¹⁵⁵ Pasquale Pistone, “Chapter 1. General Report” in Michael Lang et al (eds), “Trends and Players in Tax Policy” (IFBD, 2016) 75

¹⁵⁶ BEPS in Motion: Examining the impact of BEPS on the telecommunications sector (EY) <<https://www.ey.com/gl/en/industries/telecommunications/ey-beps-in-motion>> accessed 21 October 2018

reputation.¹⁵⁷ Coordinated approach to tax risk management creates the need to consolidate activities in tax reporting, tax policy and governance, tax risk management in a narrower sense (development of control framework for existing risks, identifying new risks), tax assurance (assessment of effectiveness of controls, their operation and design).¹⁵⁸

The starting points for analysing PE tax risk management are defining tax governance and tax compliance. Tax governance means building and maintaining framework identify, assess and manage tax risks to be confident that enterprise pays right amount of tax in the right state.¹⁵⁹ Tax governance covers the overall enterprise tax strategy, as well as internal policies addressing tax risks and external communications on tax-related matters.¹⁶⁰ A good tax corporate governance model includes a robust risk management framework and procedures to identify, implement and report on the effectiveness of internal controls to mitigate tax risks.¹⁶¹ The internal control acts as the practical dimension of governance in a rapidly changing world.¹⁶²

Effectiveness of tax management is measured by level of tax compliance in MNE. Tax compliance is a degree to which taxpayers comply with the tax law.¹⁶³ Tax compliance strategy of the company should be aligned with its strategy and corporate social responsibility values. For example, Electrolux states following: “One important aspect for Electrolux of being the best appliance company in the world is to act as a good corporate citizen and taxpayer wherever Electrolux operates.” This way this company highlights the high role of tax compliance in fulfilling corporate citizenship goals of the company. In practice, tax compliance is largely influenced by psychological and behavioural mechanisms, namely:

¹⁵⁷ Tony Elgood, Ian Paroissien and Larry Quimby, “Tax Risk Management”(PwC, 2004) 10 < <https://www.pwc.com/gx/en/tax-management-strategy/pdf/tax-risk-management-guide.pdf>> accessed 21 October 2018

¹⁵⁸ Marvin de Ridder, Managing tax: Balancing current challenge with future promise (Deloitte, 30 November – 1 December 2016) 8
<<https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-tmc-emea-conference-2016-tax-risk-management-and-control.pdf>> accessed 21 October 2018

¹⁵⁹ Corporate governance and tax governance (Australian Taxation Office, 31 May 2016)
<<https://www.ato.gov.au/Business/Privately-owned-and-wealthy-groups/Tax-governance/Corporate-governance-and-tax-governance/>> accessed 28 October 2018

¹⁶⁰ Arnaldo Marques de Oliveira Neto, *Governance and Risk Management in Taxation* (Springer, 2017) 58

¹⁶¹ Australian Government Australian Taxation Office, Tax risk management and governance review guide (18 April 2018) <[https://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Tax-risk-management-and-governance-review-guide/?page=2#Corporate governance and risk management](https://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Tax-risk-management-and-governance-review-guide/?page=2#Corporate%20governance%20and%20risk%20management)> accessed 20 October 2018

¹⁶² Arnaldo Marques de Oliveira Neto, *Governance and Risk Management in Taxation* (Springer, 2017) 53

¹⁶³ Simon James and Clinton Alley, “Tax Compliance, Self-Assessment and Tax Administration” [2002] 2(2) Journal of Finance and Management in Public Services 29

- A. firm-specific factors such its industry, size, or financial status.
- B. individual attributes of tax function employees;
- C. perceived fairness of the taxation system in terms of tax rates and individual treatment by tax authorities.
- D. level of coordination in tax payments and acceptance of compliance as the social norm.¹⁶⁴

This means that tax risk management (TRM) framework of a MNE should aim to address specifics of the business model and markets its operates at, as well as employee's attitude to tax compliance and level of coordination and knowledge exchange in the enterprise. It is notable that Discussion Draft on Additional Guidance on Attribution of Profits to Permanent Establishments does not recommend any new ways of addressing significant compliance and administrative costs of creation of new PE under lowered PE threshold.¹⁶⁵ It means that such compliance principles will be in discretion of implementing countries to design and enforce.¹⁶⁶ For MNEs, it means increasing legal uncertainty and thus higher financial, legal and reputational risks of failure to comply. To ensure efficient tax governance system and high level of tax compliance, MNEs should carefully plan their (PE) tax risk management.

3.3. Tax risk management: background

External stakeholders are increasingly demanding increasing tax transparency on all levels, including how taxes are managed and paid.¹⁶⁷ Namely, tax functions are facing challenges in form of increasing costs of non-compliance, evolving complexity of tax legislation, growing demand for developing tax controls, and need to involve top management in tax risk management.¹⁶⁸ Tax authorities approach includes more frequent risks assessment and

¹⁶⁴ Charles Vellutini, "Key Principles of Risk-Based Audits" in Munawer Sultan Khwaja (ed.), Risk-Based Tax Audits: Approaches and Country Experiences (World Bank Publications, 2011) 14

¹⁶⁵ BEPS Alert (Deloitte Tax Publications, 23 June 2017)

<<https://www.taxpublications.deloitte.co.uk/tis/dtp.nsf/ta/86A1224BED87E89580258148005A361D?OpenDocument>> accessed 21 October 2018

¹⁶⁶ BEPS Alert (Deloitte Tax Publications, 23 June 2017)

<<https://www.taxpublications.deloitte.co.uk/tis/dtp.nsf/ta/86A1224BED87E89580258148005A361D?OpenDocument>> accessed 21 October 2018

¹⁶⁷ Is Tax Risk Management important? (KPMG, 1 August 2016)

<<https://home.kpmg.com/tt/en/home/insights/2016/08/is-tax-risk-management-important-.html>> accessed 21 October 2018

¹⁶⁸ Nikhil Hira, "Managing Tax Risks: The Role of the Board: A top – down approach" (ICPAK Governance Conference, 12 April 2013) 4 <https://www.icpak.com/wp-content/uploads/2015/09/ICPAK_Corp-Gov_Risk-Mgt_10Apr13_Jona-Copy.pdf> accessed 21 October 2018

audits, increased penalty threat, and a greater international cooperation and information between tax authorities.¹⁶⁹ However, moral, ethics and social dimensions of tax are seldom subject to discussion. Thus, despite growing complexity of tax legislation with material impact on business activities, tax risk management is a little-studied area of corporate governance.¹⁷⁰ Changes in corporate attitude to tax governance are happening slowly, but some of them we can already observe. Whereas in past tax function focused on reducing costs and tax compliance, now it is becoming a more demanding corporate function that monitors the relationship between the company's tax affairs and its corporate reputation.¹⁷¹ As a result, already in 2014, companies had to spend approximately 10% more time on managing routine tax compliance and disputes/controversy.¹⁷²

Whereas tax governance is defined well in theoretical research, tax risk management (TRM) as a concept is primarily defined by consultancies that provide such services and thus create demand for TRM. Tax risk management is a part of corporate risk management which involves identifying risks, predicting their probability and seriousness of its impact, deciding what to do about them and taking action to implement these decisions.¹⁷³ In practice, TRM is described as a framework of procedures, activities, assessments and controls to promote tax governance, address and reduce risks, as well as to equip organisation with way to forecast and prepare for tax legislation changes, ensure among all stakeholders that risks are maintained at acceptable level, and ensure that tax policies and process flows are standardised and integrated within the wider organisation.¹⁷⁴ TRM includes risk management conducted by tax administrations and by taxpayers. It helps tax authorities to identify indicators that certain taxpayers or business models pose an increased tax risk to jurisdiction and whether more activities on strengthening tax

¹⁶⁹ Managing global tax risks (Ernst & Young LLP, 2003) 2

<[https://www.ey.com/Publication/vwLUAssets/EY_-_Managing_global_tax_risks/\\$FILE/EY-global-tax-risk-tool.pdf](https://www.ey.com/Publication/vwLUAssets/EY_-_Managing_global_tax_risks/$FILE/EY-global-tax-risk-tool.pdf)> accessed 21 October 2018

¹⁷⁰ Talya Segal and Warren Maroun, "Tax risk-management analysis: Comparison between the United States, the United Kingdom and South Africa" [2014] 7(2) Journal of Economic and Financial Sciences 375

¹⁷¹ Tax Risk Management: The Evolving Role of Tax Directors (Enterprise Risk Management Initiative, 31 December 2004) <<https://erm.ncsu.edu/library/article/tax-directors-role>> accessed 21 October 2018

¹⁷² Managing operational risk, 2014 Tax Risk and Controversy Survey Series (EYGM Limited, 2014) 7<[https://www.ey.com/Publication/vwLUAssets/EY-Managing-operational-tax-risk/\\$FILE/EY-managing-operational-tax-risk.pdf](https://www.ey.com/Publication/vwLUAssets/EY-Managing-operational-tax-risk/$FILE/EY-managing-operational-tax-risk.pdf)> accessed 21 October 2018

¹⁷³ Tony Merna, Faisal F. Al-Thani and Faisal F. Al-ThaniMerna, *Corporate Risk Management* (2nd edn, John Wiley & Sons, Incorporated, 2011) 44

¹⁷⁴ Tax Risk Management (KPMG) <<https://home.kpmg.com/ie/en/home/services/tax/corporate-tax/tax-risk-management.html>> accessed 21 October 2018

compliance are required¹⁷⁵ However, it is not easy to find definition of tax governance or TRM in materials of national tax authorities. Extensive definitions in English are provided only by Australian Taxation Office¹⁷⁶, the European Commission¹⁷⁷ and Chinese State Administration of Taxation.¹⁷⁸

There are different approaches to defining elements of TRM framework. One of them is to split TRM into areas based on content of activities and involved stakeholders into strategy, risk management and control environment, profile, relationships and communications, process & technology, staff, compliance, accounting, planning and coverage.¹⁷⁹ TRM inside the enterprise is enabled through tax controls framework (TCF). The 2013 OECD Report highlights the role of internal control in assuring the accuracy and completeness of the tax returns and disclosures made by an enterprise.¹⁸⁰ In practice, the scope of processes and obligations covered by TCF is wider, especially concerning PE risk management. TCF is a part of a control function of the enterprise, that helps the taxpayer to identify what tax issues to be disclosed and mitigate arising tax risks (risks of failure to show high level of tax governance and tax compliance).¹⁸¹ TCF allows to assure internal and external stakeholders, including tax authorities, that PE risk of MNE is well understood and appropriately controlled.¹⁸² From accounting perspective, tax controls ensure timely reconciliation of tax accounts, proper recording of valuation allowances, guarantee fast

¹⁷⁵ BEPS Action 13 Country-by-Country Reporting. Handbook on Effective Tax Risk Assessment (OECD, September 2017) 15 <<http://www.oecd.org/ctp/beps/country-by-country-reporting-handbook-on-effective-tax-risk-assessment.pdf>> accessed 21 October 2018

¹⁷⁶ Australian Government Australian Taxation Office, *Tax risk management and governance review guide* (18 April 2018) <<https://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Tax-risk-management-and-governance-review-guide/>> accessed 20 October 2018

¹⁷⁷ European Commission Fiscalis Risk Analysis Project Group, *Risk Management Guide for Tax Administrations* (2006)

<https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/tax_cooperation/general/overview/risk_management_guide_for_tax_administrations_en.pdf> accessed 20 October 2018

¹⁷⁸ Tax Administration (State Administration of Taxation of The People's Republic of China, 2018) <<http://www.chinatax.gov.cn/eng/n2367721/c2390301/content.html>> accessed 28 October 2018

¹⁷⁹ Bernd Erle, "Tax Risk Management and Board Responsibility" in Wolfgang Schön (eds), *Tax and Corporate Governance* (Springer, 2008) 212

¹⁸⁰ Co-Operative Tax Compliance. Building Better Tax Control Frameworks (OECD Publishing, 2016) 14 <https://www.oecd-ilibrary.org/taxation/co-operative-tax-compliance_9789264253384-en> accessed 21 October 2018

¹⁸¹ Alexey Kondrashov et al, "Tax control framework (TCF) for energy and mining" (EY, 6-8 June 2017) 10 <[https://www.ey.com/Publication/vwLUAssets/ey-tax-control-framework-tcf-for-energy-and-mining/\\$FILE/ey-tax-control-framework-tcf-for-energy-and-mining.pdf](https://www.ey.com/Publication/vwLUAssets/ey-tax-control-framework-tcf-for-energy-and-mining/$FILE/ey-tax-control-framework-tcf-for-energy-and-mining.pdf)> accessed 21 October 2018

¹⁸² Sonia Watson, Permanent Establishment risk – a new approach (PwC, 11 September 2014) <<http://pwc.blogs.com/tax/2014/09/permanent-establishment-risk-a-new-approach.html>> accessed 21 October 2018

response to new reporting requirements and financial closing procedures, improve valuation and measurement of uncertain tax positions.¹⁸³

Analysis of compound elements of TRM and TCF shows that achieving tax compliance, especially cross-borders, requires systematising multidisciplinary knowledge in international tax law and accounting. This knowledge is based on solid understanding of task division inside the company and expectations of tax authorities. Complexity of ensuring TCF shows that TRM planning and implementation should be split up in smaller areas, based on the substantial coverage. Managing PE risk is one of such areas.

3.4. PE risk management as a part of tax risk management framework

Difficulties in defining and rethinking PE threshold and further evolution of BEPS project have an important impact on MNEs. Lack of clarity in interpretations of the same concepts create a space for conflict between tax administrations and MNEs, on the one hand, and tax administrations themselves, on the other.¹⁸⁴ Tax advisors were especially concerned about the hastily considered and implemented changes and the additional problems they might create.¹⁸⁵

In first chapter, I have covered following factors that show increasing need for PE risk management, namely:

- Ongoing changes to PE concept under OECD Model Tax Convention brought by BEPS Action 7 and updated Commentaries to OECD Model Tax Convention;
- Regulatory challenges presented by digital economy at the supranational level;
- Specifics of approach of national tax authorities to interpreting PE concept;
- Scrutiny of tax authorities when it comes to willingness of MNEs to trigger activity exceptions as stated in article 5(4) of the OECD Model, which are referred to as “preparatory and auxiliary activities”.¹⁸⁶

¹⁸³ Gary Paice et al, “Managing operational risk” (EY) <<https://www.ey.com/gl/en/services/tax/tax-policy-and-controversy/ey-2014-managing-operational-tax-risk-policies-processes-and-controls>> accessed 21 October 2018

¹⁸⁴ A.J. Martín Jiménez, Preventing the Artificial Avoidance of PE Status (UN Papers on Selected Topics in Protecting the Tax Base of Developing Countries, September 2014) 4 <http://www.un.org/esa/ffd/tax/2014TBP2/Paper_PE_Status.pdf> accessed 21 October 2018

¹⁸⁵ Marie Sapirie, “Permanent Establishment and the Digital Economy” [2018] 72(4a) Bulletin for International Taxation IBFD

¹⁸⁶ Jean-François Dutriez, “Attribution of Profits to a Permanent Establishment of a Company Engaged in Online Sales of Goods through a Local Warehouse” [2018] 25(3) International Transfer Pricing 185

Proactive management of PE risk will reduce the risk on unexpected tax payments, including penalties and interest charges, identify opportunities for improvements to tax internal control framework and strengthen the ability to make timely disclosure to tax authorities proving that reasonable care has been taken to manage PE issues.¹⁸⁷ It will also help to assess risks of liability for taxes and charges relating to prior years, differing VAT obligations, and, obviously, double taxation of PE profits.¹⁸⁸ The cost of failure to perform PE risk assessment is far beyond the tax liability in the narrow sense. It can result in reputational damage, corporate liability up to criminal proceedings and piercing corporate veil, additional employer reporting obligations covering payroll and social security, immigration considerations for employees, and industry-specific regulatory issues.¹⁸⁹

To map the scope and needed effort for managing PE risk, it is important to systematise the questions that MNE should ask first. Analysis in chapter 1 has helped to identify following questions:

Table 2. Guiding questions for PE risk management¹⁹⁰

What should go right?	<ul style="list-style-type: none"> • Determination of taxable presence in the country where the enterprise is not a tax residence • Determination of income attributable to PE
How can it go wrong?	<ul style="list-style-type: none"> • Failure to identify PE • Failure to comply with reporting obligations
What are causes and consequences?	Analysed at risk identification and risk analysis stages
How likely is it to occur?	Analysed at risk ranking and prioritisation stage
What can be done to detect, control and manage identified risks?	Analysed at risk treatment stage
What are the alternatives?	To be addressed throughout risk management stages

These questions allow to ensure ongoing re-evaluation and updates in risk management processes.¹⁹¹ However, to be able to provide up-to-date answers to these questions, receiving static knowledge at the start of TRM planning is not enough – knowledge should

¹⁸⁷ Sonia Watson, “Permanent establishment risk review – what it means for you?” (PwC, 2015) <<https://www.pwc.co.uk/assets/pdf/permanent-establishment-risk-what-it-means-for-you.pdf>> accessed 21 October 2018

¹⁸⁸ Andrea Kopecek, Permanent Establishment-Risk-Check (Deloitte, 2018) <<https://www2.deloitte.com/at/de/seiten/business-in-austria/solutions/permanent-establishment-risk-check.html>> accessed 21 October 2018

¹⁸⁹ Sonia Watson, “Permanent establishment risk review – what it means for you?” (PwC, 2015) <<https://www.pwc.co.uk/assets/pdf/permanent-establishment-risk-what-it-means-for-you.pdf>> accessed 21 October 2018

¹⁹⁰ After Ariel Pinto and Luna Magpili, *Operational Risk Management* (Momentum Press, 2015) 16

¹⁹¹ Ariel Pinto and Luna Magpili, *Operational Risk Management* (Momentum Press, 2015) 82

be constantly updated. For this reason, to manage PE risk, it is vital to identify the stage of tax risk management and analyse PE concept under each of the stages. There is surprisingly little research on actual stages of tax risk assessment in framework of TRM. As a basis for my analysis, I have taken the approach present in OECD Compliance Risk Management Guidance Note¹⁹² and Risk management guide for tax administrators published by the European Commission.¹⁹³ It identifies following stages that are based on ISO 31000 Risk Management standard,¹⁹⁴ generic risk management framework and are identical to classification followed by tax administrations outside the EU¹⁹⁵:

1. Risk identification (identifying hazards and failures, adverse consequences)
2. Risk analysis (describing and quantifying risk, estimating probabilities)
3. Risk ranking, prioritisation and assessment (estimating significance of the risk and conducting cost/benefit analysis)
4. Risk treatment.
 - 4.1. Design, implement and test controls
 - 4.2. Monitoring, assurance and escalation.¹⁹⁶¹⁹⁷

I will use this TRM stage breakdown for a couple of reasons. First, using it allows to better understand approach of tax authorities to tax risk management and thus equips MNEs with an effective approach to analysis taxation regimes. Second, it has a detailed and practically oriented breakdown of risk management stages that allows to prioritise goals and strategies in the situation when resources of the enterprise are inevitably restricted. Third, this approach is based on the long-established approach to corporate risk management, which, is in its turn, based on experience from different industries and projects. Namely, back in 1995 researchers split corporate risk management into following stages: identification of risk or uncertainties, analysis of implications, response to minimise risk, allocation of

¹⁹² Compliance Risk Management: Managing and Improving Tax Compliance. Guidance Note (OECD, October 2004) 9 <<https://www.oecd.org/tax/administration/33818656.pdf>> accessed 29 October 2018

¹⁹³ European Commission Fiscalis Risk Analysis Project Group, *Risk Management Guide for Tax Administrations* (2006) <https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/tax_cooperation/gen_overview/risk_management_guide_for_tax_administrations_en.pdf> accessed 20 October 2018

¹⁹⁴ ISO 31000: Risk Management: Principles and Guidelines (International Organization for Standardization, 2009), Section 4.1

¹⁹⁵ See Tax Administration (State Administration of Taxation of The People's Republic of China, 2018) <<http://www.chinatax.gov.cn/eng/n2367721/c2390301/content.html>> accessed 28 October 2018

¹⁹⁶ Nikhil Hira, "Managing Tax Risks: The Role of the Board A top – down approach" (ICPAK Governance Conference, 12 April 2013) 6 <https://www.icpak.com/wp-content/uploads/2015/09/ICPAK_Corp-Gov_Risk-Mgt_10Apr13_Jona-Copy.pdf> accessed 21 October 2018

¹⁹⁷ David L. Olson, Desheng Dash Wu, *Enterprise Risk Management Models* (Springer, 2017) 8

appropriate contingencies.¹⁹⁸ Chapman and Ward identified following stages: defining, focusing, identifying, structuring, taking ownership, estimation, evaluating and planning.¹⁹⁹ Thus, methodology I am using for TRM planning is based on both general project management theory and practical approach of OECD and tax authorities of different states and legal systems. In following sections of the chapter, I will look how to address PE tax risk of each of the stages for different elements of a value chain of MNE.

3.5. Risk identification

Risk identification is the first stage of TRM, during which potential risks that threaten the objectives of the organisation are recorded. If risks are not identified already at the first stage, there is a high chance that they will never be covered later.²⁰⁰ Thus, it is important to focus on what elements of operating models and general functioning of enterprise can trigger PE risk.

The enterprise should consider tax risks in following areas:

1. Corporate structure – international tax presence arising from the organisational chart of enterprise;
2. Operational – planning and strategy;
3. Legislation;
4. Deals — major transactions, e.g. due to restructuring of enterprise;
5. Operations – day-to-day processes, value chain and management decisions.²⁰¹

This breakdown makes it clear that PE risk may arise in any sector of business activity. Moreover, ongoing changes brought by BEPS Actions create the risk that tax authorities may re-evaluate even routine and long-established activities of MNE, such as its agency arrangements. In practice, this may impact MNE status in many ways. Namely, EY's 2014

¹⁹⁸ Tony Merna, Faisal F. Al-Thani and Faisal F. Al-Thani Merna, *Corporate Risk Management* (2nd edn, John Wiley & Sons, Incorporated, 2011) 45 citing Nigel Smith, *Engineering Project Management* (Blackwell Science, 1995)

¹⁹⁹ Tony Merna, Faisal F. Al-Thani and Faisal F. Al-Thani Merna, *Corporate Risk Management* (2nd edn, John Wiley & Sons, Incorporated, 2011) 45-46 citing Chris Chapman and Stephen Ward, *Project Risk Management: Processes, Techniques and Insights* (John Wiley & Sons, 1997)

²⁰⁰ European Commission Fiscalis Risk Analysis Project Group, *Risk Management Guide for Tax Administrations* (2006) 21

<https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/tax_cooperation/gen_overview/risk_management_guide_for_tax_administrations_en.pdf> accessed 20 October 2018

²⁰¹ Nikhil Hira, "Managing Tax Risks: The Role of the Board A top – down approach" (ICPAK Governance Conference, 12 April 2013) 9 <https://www.icpak.com/wp-content/uploads/2015/09/ICPAK_Corp-Gov_Risk-Mgt_10Apr13_Jona-Copy.pdf> accessed 21 October 2018

Tax Risk and Controversy Survey identified four main sources of risks — reputation, legislative, enforcement and operational.²⁰² “Compliance risk”, or “Legislative risk” means the risk of misapplication of the relevant tax laws due to fraud or error, whereas “Operational risk” is “the risk of loss resulting from inadequate or failed internal processes, people, systems or external events”.²⁰³ Enforcement risk is left out of scope based on research scope restrictions.

3.6. Risk analysis

The goal of risk analysis stage is to systematically weigh and group identified risks based on frequency (the number of risks), the gravity (the chance that the risk materializes) and consequence (in this case, amount of taxable profit of PE).²⁰⁴ It allows to identify root causes of risks.²⁰⁵ Analysis of PE concept in chapter 1 and exploring risk identification stage have shown that PE risk may impact all spheres of business activities of MNE. In case of telecommunications sector MNE, it will mean coverage of both procure-to-pay (procurement side) and order-to-cash accounting cycles as shown below.

Table 3. PE risk matrix in post-BEPS environment (Vreeswijk, Tan)²⁰⁶

	Plan	Design	Buy	Make	Store and move	Market and sell	Service
High risk						Comissionaire (principal role in conclusion of contracts)	
			Procurement office (goods for resale)	Toll manufactu ring ²⁰⁷ (access to inventory)	Group logistics warehouse (access to inventory)	Comissionaire (third-party or multiple contracts)	
			Procurement office	Toll manufactu	Group logistics warehouse	Limited risk local distributor (flash	Multiple contracts<

²⁰²Managing operational risk, 2014 Tax Risk and Controversy Survey Series (EYGM Limited, 2014) 1
<[https://www.ey.com/Publication/vwLUAssets/EY-Managing-operational-tax-risk/\\$FILE/EY-managing-operational-tax-risk.pdf](https://www.ey.com/Publication/vwLUAssets/EY-Managing-operational-tax-risk/$FILE/EY-managing-operational-tax-risk.pdf)> accessed 21 October 2018

²⁰³ Talya Segal and Warren Maroun, “Tax risk-management analysis: Comparison between the United States, the United Kingdom and South Africa” [2014] 7(2) Journal of Economic and Financial Sciences 375

²⁰⁴ European Commission Fiscalis Risk Analysis Project Group, *Risk Management Guide for Tax Administrations* (2006) 27

<https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/tax_cooperation/gen_overview/risk_management_guide_for_tax_administrations_en.pdf> accessed 20 October 2018

²⁰⁵ John Fraser and Betty J. Simkins (eds), *Enterprise Risk Management: Today’s Leading Research and Best Practices for Tomorrow’s executives* (John Wiley & Sons, 2010) 107

²⁰⁶ Adapted and clarified from Joost Vreeswijk and Ai-Leen Tan, “The impact of BEPS Action 7 on operating models” (International Tax Review, 8 March 2016)

<<http://www.internationaltaxreview.com/Article/3535787/The-impact-of-BEPS-Action-7-on-operating-models.html>> accessed 21 October 2018

²⁰⁷ In a toll manufacturing arrangement, an enterprise provides its raw materials or semi-finished goods to a third-party service provider. See Business Dictionary <<http://www.businessdictionary.com/>> accessed 21 October 2018, Chris Finnerty et al, *Fundamentals of International Tax Planning* (IFBD, 2007) 184-185

			(indirect procurement) ²⁰⁸	ring ²⁰⁹ (restricted access to inventory)	(restricted access)	title – taking title momentarily before passing title to customer ²¹⁰	one year
			Purchase representative	Contract manufacturing ²¹¹	Third-party logistics warehouse (access to stock) ²¹²	Limited risk local distributor (with inventory)	Multiple contracts > one year
Low risk	Centralised planning	Centralised design & development	Local procurement office ²¹³	Full risk local manufacturing	Third-party logistics warehouse (restricted access)	Full risk local distributor	Full local after-sales service

To group the PE risks on a higher level, I will simplify the matrix of Vreeswijk and Tan, by splitting value chain into R&D activities, transportation (including warehousing), sales and consumer use, that may also cover after-sales services. The chart below also shows that PE risk management is likely to entail interaction with internal (employees) and external (suppliers, agents) stakeholders.

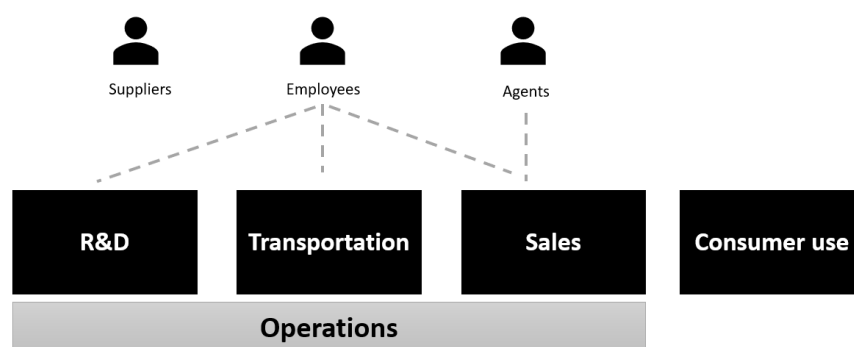


Chart 4. Simplified value chain model for PE risk assessment

Mapping PE risks in a detailed risk matrix and providing a high-level classification of business creates a solid basis for defining what risks MNE should address first at the stage of PE risk ranking, prioritisation and assessment.

²⁰⁸ See Chris Finnerty et al, *Fundamentals of International Tax Planning* (IFBD, 2007) 202

²⁰⁹ On considering toll manufacturing arrangements a PE, see Jonathan Schwarz, Schwarz on Tax Treaties” (2nd edn, Wolters Kluwer, 2011) 147

²¹⁰ See Chris Finnerty et al, *Fundamentals of International Tax Planning* (IFBD, 2007) 195

²¹¹ In contract manufacturing, a business pays a foreign business to manufacture its product and market it in the foreign country, under the name of domestic business. See Business Dictionary <<http://www.businessdictionary.com/>> accessed 21 October 2018

²¹² See Chris Finnerty et al, *Fundamentals of International Tax Planning* (IFBD, 2007) 203

²¹³ In some cases, purchasing function may be considered an “essential and significant part” of MNE activity and trigger PE. See 2017 OECD Model Tax Convention on Income and On Capital 135-136 (Commentary to Article 5(5), Para 68)

3.7. PE risk ranking, prioritisation and assessment: three key PE risks in a value chain

Main aim of this stage to choose which risks are to be treated under available treatment forms and resources (including time and competence). To perform this stage, one need to gather and process information about risks and about available resources.²¹⁴

Table 4. PE risk prioritisation

R&D	Transportation	Sales	Consumer use
	<ul style="list-style-type: none"> Warehouses²¹⁵ 	<ul style="list-style-type: none"> Dependent agent risk 	
General (at all value chain stages): Employee mobility and functions <ul style="list-style-type: none"> Home office Secondment Acting as dependent agent 			

I would like to prioritise chosen risks (PE risks arising from employee mobility, warehouse PE risk, and dependent agent PE risk at distribution stage) for following reasons. First, these risks are almost inevitable regardless of specifics of industry. Second, regardless these risks PE concept has recently experienced changes. Third, these risks are largely framed during interaction with internal and external stakeholders, whose actions are difficult to control both due to reporting specifics (e.g. agent's obligations under applicable laws) and geographical distance (e.g. employees on the other continent). Fourth, analysing their complexity provides an illustrative basis to identify PE risks stemming from other stages or elements of operating model.

Once I have prioritised the risks, I would like to focus on its initial assessment. Dependent agent risk is further addressed in chapter 3. For this reason, I provide only a high-level assessment of dependent agent PE risk in this section.

3.7.1. Employee mobility

Virtualisation (a trend when MNEs gradually replace physical centralisation with a more virtual model) scatters people around the globe and potentially creates a taxable nexus.²¹⁶

²¹⁴ European Commission Fiscalis Risk Analysis Project Group, *Risk Management Guide for Tax Administrations* (2006) 30
https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/tax_cooperation/general/overview/risk_management_guide_for_tax_administrations_en.pdf accessed 20 October 2018

²¹⁵ Susan van der Ham and Robert Halat, "Implications of the new permanent establishment definition on retail and consumer multinationals" (PwC Germany, 2016)
<https://www.pwc.com/gx/en/tax/publications/transfer-pricing/perspectives/assets/tp-16-implications.pdf> accessed 21 October 2018

Operational model of MNE creates the need for strengthening employee mobility, flexibility and competence. It results in growing popularity of such arrangements as remote work from home office and secondment (temporary transfer of an official or worker to another position or employment). In addition to that, employees can also act as agents of an enterprise, triggering dependent agent PE risk that will be discussed separately in more detail. OECD Model mentions an interesting example of a “painter, who, for two years, spends three days a week in the large office building of its main client”, thus creating painter's own PE at that office building.²¹⁷ This example shows that the analysis of relatively most important functions of the painter’s business is the decisive criterion for identifying whether PE exists. Also, employee mobility together with broadening of their function can trigger PE in cases when employees working in the source state “take an active part in the negotiation of important part of contracts for the sale of goods to buyers” in the source state, as these activities would amount to essential part of the business, not just auxiliary activities.²¹⁸ Regarding home office of employee, OECD Model states that performing work from the home office of an individual should not automatically mean that location is at the disposal of the enterprise, as working remotely from home is likely to be only incidental.²¹⁹ When an employee performs services, such as consulting, for the foreign company, it can result in PE in light of lowered PE threshold.²²⁰ In contract, supervisory activities at the PE are unlikely to trigger PE, except for cases of exceptionally long duration of such activities.²²¹

When assessing PE risks rising from employee mobility, MNE should answer following questions:

²¹⁶ Axel Smits and Isabel Verlinden, “Permanent Establishments 2.0: At the heart of the matter” (PwC, 2013) 15 <<https://www.pwc.com/gx/en/tax/publications/assets/pwc-permanent-establishments-at-the-heart-of-the-matter-final.pdf>> accessed 21 October 2018

²¹⁷ 2017 OECD Model Tax Convention on Income and On Capital 120 (Commentary to Article 5, Para 17)

²¹⁸ 2017 OECD Model Tax Convention on Income and On Capital 137 (Commentary to Article 5, Para 72)

²¹⁹ 2017 OECD Model Tax Convention on Income and On Capital 120 (Commentary to Article 5, Para 18)

²²⁰ Alfred Storck and Alexander Zeiler, “Lang et al (Eds), The OECD-Model-Convention and its Update 2014 241Beyond the OECD Update 2014: Changes to the Concepts of Permanent Establishments in the Light of the BEPS Discussion” in Michael Lang et al (eds), *The OECD-Model-Convention and Its Update 2014* (Linde Verlag, 2014) 251-252

²²¹ Alfred Storck and Alexander Zeiler, “Lang et al (Eds), The OECD-Model-Convention and its Update 2014 241Beyond the OECD Update 2014: Changes to the Concepts of Permanent Establishments in the Light of the BEPS Discussion” in Michael Lang et al (eds), *The OECD-Model-Convention and Its Update 2014* (Linde Verlag, 2014) 251-252

- When employees head for an assignment to another country, will they work at a fixed location there (amounting to “fixed place of business”, one of key elements of PE)?
- Are employees going to use facility “at the disposal of” enterprise?
- Are activities performed by employees long-term and habitual? What are main characteristics of work performed at the home office in relation to the job function of the employee and the business model of the employer?²²² For example, under Finnish Tax Administration guidelines, rendering PE in home office requires that the employee has allocated a space to work from home “on a permanent basis rather than for non-recurrent or random performance of work activities, or carrying out auxiliary or preparatory activities”.²²³
- Are there cases of seconding employees or temporarily assigning them for a work in a source State?²²⁴
- What is the type of influence the employer has on managing the home office as business premises?²²⁵

In light of this, it is essential to include monitoring the presence of employees in particular countries and extent of their activities when planning tax controls addressing PE risk.²²⁶ Full understanding of their functional profile and reporting hierarchy of employees is a crucial element in ensuring tax compliance not only for wage tax, but also for corporate taxes.²²⁷ Virtualisation also increases the role of HR departments in monitoring where people are deployed and in what roles, which is a challenging function.²²⁸ All in all, both

²²² Adam Kefford and Stuart Rogers, “Permanent establishment risk: working from home” (Tax Journal, 23 June 2017) 19 <<http://www.francisclark.co.uk/files/news/original/170626081927-TJ2017Issue1359AAE.pdf>> accessed 21 October 2018

²²³ Income taxation of foreign corporate entities (VERO, 30 April 2018) < <https://www.vero.fi/en/detailed-guidance/guidance/47806/income-taxation-of-foreign-corporate-entities/>> accessed 10 May 2018

²²⁴ Permanent establishment risk checklist (Velocity, 26 February 2018) <<https://velocityglobal.com/blog/permanent-establishment-risk-checklist/>> accessed 21 October 2018

²²⁵ Adam Kefford and Stuart Rogers, “Permanent establishment risk: working from home” (Tax Journal, 23 June 2017) 19 <<http://www.francisclark.co.uk/files/news/original/170626081927-TJ2017Issue1359AAE.pdf>> accessed 21 October 2018

²²⁶ Sonia Watson, Permanent Establishment risk – a new approach (PwC, 11 September 2014) <<http://pwc.blogs.com/tax/2014/09/permanent-establishment-risk-a-new-approach.html>> accessed 21 October 2018

²²⁷ Mark Bonekamp, Peter Karman and Maurits Stuyt, “Cross-Border Employment: Aligning Corporate Income Tax, Transfer Pricing and Wage Tax” [2017] 24(5) International Transfer Pricing Journal 363

²²⁸ Axel Smits and Isabel Verlinden, “Permanent Establishments 2.0: At the heart of the matter” (PwC, 2013) 15 <<https://www.pwc.com/gx/en/tax/publications/assets/pwc-permanent-establishments-at-the-heart-of-the-matter-final.pdf>> accessed 21 October 2018

employee and employer functions should be considered altogether to identify whether an employee triggers PE presence.²²⁹

Analysis has shown that employee mobility can create a significant level of PE risk for several reasons. First, there is no high-level analysis of features that would trigger PE in case of employment relationship – analysis is provided on case-by-case basis, primarily in case law. Second, this analysis operates qualitative criteria of nature of work (scope of tasks and temporality) and of employer control. These criteria are difficult to identify, as HR function may not have visibility to the scope of tasks that employee actually performs. This increases risk of information asymmetry, when one party is better informed than the other.

3.7.2. Warehousing

Warehouse management is a significant element of business in consumer electronics and becomes even more complex due to globalisation and emergence of multiple dispatcher centres with sophisticated logistics network.²³⁰ Analysis of PE risk in case of warehousing is of growing importance due to OECD tendency to apply economic/substance test. For example, regional warehouses and delivery centres play a vital role in establishment of online stores and digital marketing operations without creating any other physical fixed place of business in a source state.²³¹

To capture sales of goods sold online and then delivered from the warehouse, in the post-BEPS era, a warehouse triggers PE status if its activities constitute core business activities of the enterprise.²³² Namely, as a general rule, when warehouse of an enterprise is maintained by third party, it should not constitute a PE for an enterprise as it can fall under one of the exceptions under Article 5(4) of the OECD Model.²³³ However, if an enterprise has an unlimited access to warehouse to inspect goods, the character of these activities should be assessed to see whether warehouse actually falls under exception of preparatory

²²⁹ Kasper Dziurdz, “Dependent Agent PE Created by an Employee: Remuneration “Borne by” under Article 15(2)(c) of the OECD Model?” in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 261

²³⁰ Hui Ming Wee, Mauricio F. Blos, and Wen-Hsiung Yang, “Risk management in logistics” [2012] *Intelligent Systems Reference Library* 3

²³¹ Yasin Uslu, “An Analysis of “Google Taxes” in the Context of Action 7 of the OECD/G20 Base Erosion and Profit Shifting Initiative” [2018] 72(4a) *Bulletin for International Taxation IFBD* accessed 20 October 2018

²³² Jean-François Dutriez, “*Attribution of Profits to a Permanent Establishment of a Company Engaged in Online Sales of Goods through a Local Warehouse*” [2018] 25(3) *International Transfer Pricing Journal* 196

²³³ Georg Kofler, Gunter May and Christoph Schlager, “Taxation of the Digital Economy: “Quick Fixes” or Long-Term Solution” [2017] 12 *European Taxation* 527

or auxiliary activity.²³⁴ However, a need to quickly deliver goods to the clients will be a key element of the e-commerce model, and thus it is unlikely that maintaining a local warehouse will fall under auxiliary activity exception.²³⁵ Moreover, if maintaining such a warehouse requires a number of employees mainly to store and deliver goods sold online, auxiliary activity exception will not apply.^{236 237} Also, Article 13 of MLI highlights that tax authority should assess whether overall activity of a deemed PE, not separate activities have a preparatory or auxiliary character.²³⁸ Additionally, an anti-fragmentation rule prevents enterprises from escaping PE scope by spreading multiple entities of the supply chain across numerous jurisdictions.²³⁹

Analysis shows that managing PE risk in warehouse operations is likely to be closely connected with managing employee mobility risks, as employees of MNE are likely to be responsible for goods inspection, storage and delivery. In case when warehouse is managed by a third party, risk is multiplied.

3.7.3. Dependent agent model

Sales agency, commissionaire agreements, limited risk distributorship and sales branches are essential transaction models for distribution, including consumer electronics sector.²⁴⁰ Some of these models increase the risk that agent representing interests in concluding contracts in a foreign country will fall under the scope of Article 5(5) of OECD Model based on economic reality of the transaction.²⁴¹ In light of BEPS Actions, we can already see a trend of businesses modifying their distribution models to get rid of elements of commissionaire structures that can fall under dependent agent PE scope.²⁴²

²³⁴ 2017 OECD Model Tax Convention on Income and on Capital, Commentary 134-135

²³⁵ Eva Escribano López, “An opportunistic, and yet appropriate, revision of the source threshold for the twenty-first century tax treaties” [2015] 43(1) Intertax 12

²³⁶ Vishesh Dhuldhoya, “The Future of the Permanent Establishment Concept” [2018] 72 (4a) Bulletin for International Taxation 11 IBFD (accessed 5 March 2018)

²³⁷ Lifting the mist: Sustainable distribution models in the post-BEPS world (EYGM Limited, 2017) 4 <[https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/\\$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf](https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf)> accessed 21 October 2018

²³⁸ Karoline Spies, “Permanent Establishment versus Fixed Establishment: The Same or Different?” [2017] 71(12) Bulletin for International Taxation 709

²³⁹ Marcel Olbert and Cristoph Spengel, “International Taxation in the Digital Economy: Challenge Accepted?” [2017] 9(1) World Tax Journal 12

²⁴⁰ Lifting the mist: Sustainable distribution models in the post-BEPS world (EYGM Limited, 2017) 7 <[https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/\\$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf](https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf)> accessed 21 October 2018

²⁴¹ Chris Finnerty et al, *Fundamentals of International Tax Planning* (IFBD, 2007) 198

²⁴² Lifting the mist: Sustainable distribution models in the post-BEPS world (EYGM Limited, 2017) 4 <[https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/\\$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf](https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf)> accessed 21 October 2018

In contrast to employee mobility and warehousing risks, that require more general economic substance analysis, dependent agent PE risk analysis deserves more detailed approach based on applicable law. The reasons for it is the complex textual provisions on dependent agent PE conditions that can have conflicting interpretations in civil and common law systems, as well as difficulties to predict how BEPS Action 7 will impact practical implementation of PE concept. For this reason, I will address the dependent agent PE risk further in chapter 3 where I will present the practical application of risk management stages under Article 5(5) of OECD Model Tax Convention.

3.8. Risk treatment through tax controls framework for PE

Risk treatment aims to reduce the chances that risk events will occur and consequences if such risks occur.²⁴³ Risk treatment means modifying a system or its elements to affect particular risk events, which is a follow-up action after risks are identified and described.²⁴⁴ Design of risk treatment strategies should take into account such factors as tax risk category, potential impact, likelihood, urgency (factors already addressed at risk prioritization stage), as well as specific factors such as mitigation strategy, its benefits, estimated costs to benefit and available resources.²⁴⁵ Thus, risk treatment strategies focus on detection and control at the stage of reducing chances of occur, and recovery plans to mitigate consequences once risk events took place.²⁴⁶ It involves both development of tax controls and it testing to ensure that they operate effectively.

3.8.1. Design and implement controls

To formulate approach to a taxpayer, tax authorities aim to understand the general tax governance framework of an enterprise and how key stakeholders identify their key responsibilities, risks present at the market and how enterprise board are informed about risks, as well as ways how enterprises identify significant and new transactions and explain significant accounting differences.²⁴⁷ All in all, tax authorities should first get acquainted with and understand the business processes of the enterprise before assessing its tax

²⁴³ Ariel Pinto and Luna Magpili, *Operational Risk Management* (Momentum Press, 2015) 67

²⁴⁴ Ariel Pinto and Luna Magpili, *Operational Risk Management* (Momentum Press, 2015) 67

²⁴⁵ Nikhil Hira, "Managing Tax Risks: The Role of the Board A top – down approach" (ICPAK Governance Conference, 12 April 2013) 11 <https://www.icpak.com/wp-content/uploads/2015/09/ICPAK_Corp-Gov_Risk-Mgt_10Apr13_Jona-Copy.pdf> accessed 21 October 2018

²⁴⁶ Ariel Pinto and Luna Magpili, *Operational Risk Management* (Momentum Press, 2015) 68

²⁴⁷ Australian Government Australian Taxation Office, *Tax risk management and governance review guide* (18 April 2018) <https://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Tax-risk-management-and-governance-review-guide/?page=2#Director_s_summary> accessed 20 October 2018

controls framework.²⁴⁸ For these reasons, TCF should be clear both for internal and external stakeholders.

TCF goals span well beyond the compliance with reporting purposes. Primarily, it should establish risk ownership by identifying who will have a main role in managing PE risk – CFO, tax function or someone else.²⁴⁹ TCF allows to manage tax risk with clarity and confidence through ensuring coordinated approach, gradual building of framework components, enabling consistency of PE risks controls with broader tax reporting and transparency requirements, as well as with sound risk management policies.²⁵⁰ Tax control framework enables planning in detail how to address PE risks in general tax control framework and specific tax controls, plan communications to multiple stakeholders (from sales to HR), and assess the need for specific operational controls based on business model of the company (to be discussed further also in chapter 3). Tax controls lifetime includes planning (defining objectives and scope of TCF), insight (determining material tax risks and status of tax risk management), design (designing and formulating tax procedures), implementation (embedding tax controls into processes and systems) and monitoring (testing its effectiveness).²⁵¹

Key stakeholders of tax control framework, in addition to directly identified risk owners, are board, CFO, Audit committee, Risk function (at strategy and governance level), Heads of Divisional Finance/Region CFOs, Group Tax, HR (building tax controls framework and driving processes), Internal audit (assurance).²⁵² External stakeholders interested in

²⁴⁸ Tax Control Framework. From a focus on risks to being in control: a different approach (Netherlands Tax and Customs Administration, March 2008) 19
<https://download.belastingdienst.nl/itd/beleid/overige/tax_control_framework.pdf> accessed 21 October 2018

²⁴⁹ Tony Elgood, Ian Paroissien and Larry Quimby, “Tax Risk Management”(PwC, 2004) 10
<<https://www.pwc.com/gx/en/tax-management-strategy/pdf/tax-risk-management-guide.pdf>> accessed 21 October 2018

²⁵⁰ Marvin de Ridder, Managing tax: Balancing current challenge with future promise (Deloitte, 30 November – 1 December 2016) 21
<<https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-tmc-emea-conference-2016-tax-risk-management-and-control.pdf>> accessed 21 October 2018

²⁵¹ Marvin de Ridder, Managing tax: Balancing current challenge with future promise (Deloitte, 30 November – 1 December 2016) 6
<<https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-tmc-emea-conference-2016-tax-risk-management-and-control.pdf>> accessed 21 October 2018

²⁵² Marvin de Ridder, Managing tax: Balancing current challenge with future promise (Deloitte, 30 November – 1 December 2016) 6
<<https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-tmc-emea-conference-2016-tax-risk-management-and-control.pdf>> accessed 21 October 2018

effective and consistent reporting of taxes are not only tax authorities, but also investors, customers, lenders, employees, tax authorities and society as a whole.²⁵³

OECD identifies following essential building blocks of TCF that are consistent with internal control models such as COSO:

- Tax strategy is established, clearly documented, including assignment of ownership, applied comprehensively. For instance, for Electrolux, one of main goals of tax strategy is stated simply – “the right amount of taxes are paid in the right country” to ensure reputation of “as the best-in-class corporate citizen in every jurisdiction”.²⁵⁴ Its Group Tax Policy aims to provide “guiding principles for employees involved in tax matters, their key responsibilities, systems and controls, and details on oversight of tax matters in general”.²⁵⁵
- Responsibilities for the design, implementation and effectiveness of the tax control framework are clearly assigned. For instance, Electrolux has a Tax Board, that includes inter alia, the CFO of the Group and Head of Global Tax & Accounting and ensures that “material tax related matters are handled in a consistent way”).²⁵⁶
- Governance (including rules and reporting procedures) is documented, ensuring that transactions and events comply with applicable regulations and internal guidelines. Electrolux, for instance, highlights the communication aspect of document exchange, stating that “information on changes needed and ongoing projects etc. are shared internally to keep all parts of the organization up to date”.²⁵⁷
- Testing of compliance with policies of processes under TCF is under constant monitoring and maintenance.

²⁵³ Marvin de Ridder, Managing tax: Balancing current challenge with future promise (Deloitte, 30 November – 1 December 2016) 6
<<https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-tmc-emea-conference-2016-tax-risk-management-and-control.pdf>> accessed 21 October 2018

²⁵⁴ Tax policy (Electrolux, 10 July 2018) 4 <<https://www.electroluxgroup.com/en/tax-policy-22164/>> accessed 22 October 2018

²⁵⁵ Tax policy (Electrolux, 10 July 2018) 4 <<https://www.electroluxgroup.com/en/tax-policy-22164/>> accessed 22 October 2018

²⁵⁶ Section 3(3) of Tax policy (Electrolux, 10 July 2018) 4 <<https://www.electroluxgroup.com/en/tax-policy-22164/>> accessed 22 October 2018

²⁵⁷ Tax policy (Electrolux, 10 July 2018) 4 <<https://www.electroluxgroup.com/en/tax-policy-22164/>> accessed 22 October 2018

- TCF provides assurance to internal and external (tax authorities) stakeholders that tax risks are controlled, and these controls provide reliable outputs.²⁵⁸

For these reasons, a starting point of addressing PE risk is to ensure that PE risk is captured under general tax and reporting controls that enable correct reflection of transactions in accounting system and regulate intracompany transactions at a general level.

Once the enterprise has the understanding that general tax controls framework allows to ensure tax compliance on more general level, enterprise may consider taking specific actions, that cover PE risk more specifically.

3.8.2. Monitoring and testing.²⁵⁹

An enterprise should be able to test how its tax strategy and specific control function in day-to-day operations to see whether they are effective and how they contribute to overall performance of the tax strategy.²⁶⁰ This includes testing both design (assessing adequacy of its structure and provisions) and operational effectiveness of control (assessing how it has actually helped to mitigate risk).²⁶¹ Thus, quite a big part of monitoring will happen on more general level of tax strategy. In other words, control effectiveness cannot be assessed just based on one separate criterion, as they are interrelated.²⁶² However, there are couple of testing aspects that will be specific to PE risk management.

MNEs can use such methods to test controls as inquiries with key stakeholders listed above, inspecting relevant documentation and performing business model and transaction analysis.

²⁶³ The latter includes stages of understanding impact of PE provisions on transactions,

²⁵⁸ Co-Operative Tax Compliance. Building Better Tax Control Frameworks (OECD Publishing, 2016) 15 <https://www.oecd-ilibrary.org/taxation/co-operative-tax-compliance_9789264253384-en> accessed 21 October 2018

²⁵⁹ Nikhil Hira, “Managing Tax Risks: The Role of the Board: A top – down approach” (ICPAK Governance Conference, 12 April 2013) 6 <https://www.icpak.com/wp-content/uploads/2015/09/ICPAK_Corp-Gov_Risk-Mgt_10Apr13_Jona-Copy.pdf> accessed 21 October 2018

²⁶⁰ Rudy Verstappen, Tjeerd van den Berg and Hifsa Younus, “Tax Transparency Benchmark 2017” (PwC, November 2017) 13 <<https://www.pwc.nl/nl/assets/documents/pwc-tax-transparency-benchmark-2017.pdf>> accessed 21 October 2018

²⁶¹ Australian Government Australian Taxation Office, Tax risk management and governance review guide (18 April 2018) <<https://www.ato.gov.au/business/large-business/in-detail/key-products-and-resources/tax-risk-management-and-governance-review-guide/?page=5#TestingOperationalEffectivenessOfControl>> accessed 21 October 2018

²⁶² Internal Control, A Practical Guide (KPMG, October 1999) 42 <http://www.ecgi.org/codes/documents/kpmg_internal_control_practical_guide.pdf> accessed 21 October 2018

²⁶³ Australian Government Australian Taxation Office, Tax risk management and governance review guide (18 April 2018) <<https://www.ato.gov.au/business/large-business/in-detail/key-products-and-resources/tax-risk-management-and-governance-review-guide/?page=5>> accessed 21 October 2018

identifying key stages of each model or transaction that are especially prone to PE risk and, last, identifying how controls could and actually have mitigated the risk over the applicable testing period.²⁶⁴ To be more exact, testing may cover inspection of checklists and communication protocols.²⁶⁵ For example, Electrolux conducts both formal and informal procedures for independent testing purposes at least twice a year. Its results are verified by external audit when larger reporting units are in question, and improvements are suggested.²⁶⁶

Analysis of goals of risk treatment has shown that both design of tax controls and its ongoing testing are inevitable stages of the process that happen in cycle. Constant monitoring is especially important in light of dynamic changes to PE taxation regime due to BEPS Action. Periodic monitoring activities allow to build an effective system to communicate to a wide number of stakeholders how MNE identifies risks, treats them and makes risk treatment system even better.

3.9. Conclusions

Risk management involves identifying risks, assessing their probability and level of their impact, deciding what to do about them and implementing follow-up actions.²⁶⁷ Industry trends, such as growing employee mobility and increasing complexity of logistics and distribution chains multiplies the risk that established business routines or innovative business models will fall under PE scope. Due to trend of lowering PE threshold, PE status may come as a surprise to stakeholders. To minimize uncertainty, MNE should build a systematised approach to PE risk management.

This chapter has covered how addressing and mitigating PE risk should be a systematized and well-documented activity and a part of a more high-level effort of the enterprise to ensure tax compliance through developing tax strategy and tax governance framework. Having common vision on tax compliance and wider scope of possible tax risks that is

²⁶⁴ Australian Government Australian Taxation Office, Tax risk management and governance review guide (18 April 2018) <<https://www.ato.gov.au/business/large-business/in-detail/key-products-and-resources/tax-risk-management-and-governance-review-guide/?page=5>> accessed 21 October 2018

²⁶⁵ Australian Government Australian Taxation Office, Tax risk management and governance review guide (18 April 2018) <https://www.ato.gov.au/Business/Large-business/In-detail/Key-products-and-resources/Tax-risk-management-and-governance-review-guide/?page=5#How_to_test_controls> accessed 21 October 2018

²⁶⁶ Monitor and Improve (Electrolux, 2012) <<https://www.electroluxgroup.com/annualreports/2012/en/corporategovernance/internalcontrolover/monitorandimprove/monitor-and-improve.html>> accessed 30 October 2018

²⁶⁷ Tony Merna, Faisal F. Al-Thani and Faisal F. Al-Thani Merna, Corporate Risk Management (2nd edn, John Wiley & Sons, Incorporated, 2011) 65

communicated to key stakeholders is the only way to ensure that the enterprise will ensure compliance with complex and changing PE taxation regulations all over the world.

4. MANAGING DEPENDENT AGENT PE RISK

4.1. Introduction

It would be too easy to circumvent PE taxation if there was no specific PE fiction addressing cases of foreign agency, when a person performs legal acts on behalf of another person abroad.²⁶⁸ Dependent agent PE is created when an enterprise (a resident of a contracting state) is represented by an agent (as defined by Article 5(5) of OECD Model) in the host country and becomes taxable in that host country.²⁶⁹ Dependent agent may act in different ways – for example, employees based in the host state with the authority to conclude contracts on behalf of the enterprise, associated enterprises with the power to conclude contracts, and unassociated third parties whose economic relations with the enterprise give these third parties a status of dependent agent.²⁷⁰ PE may also exist when the sales representative's authority handles the customers' warranty and statutory warranty claims.²⁷¹

In this chapter, I will look into the permanent establishment risk management in case of distribution models of MNEs. First, I will explore background of dependent agent PE concept. This will allow to identify primary goals of this concept and trends of its development in international taxation regulation. Next, I will analyse the current OECD Model Tax Convention provisions on dependent agent PE. This will help to identify the risk elements that construct the definition of PE. Its detailed analysis will enable to prioritise, assess and analyse risks, as well as to come up with risk treatment strategy.

4.2. Background of dependent agent PE concept

In case of a single enterprise, firm boundaries are defined by the fixed place of business where enterprise operates (substantial physical presence criterium).²⁷² In case of agency,

²⁶⁸ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 463

²⁶⁹ Jitendra Jain, “Dependent Agent Permanent Establishment After MLI... Nothing Permanent About It” (BloombergQuintOpinion, 6 August 2017) <https://www.bloombergquint.com/opinion/dependent-agent-permanent-establishment-after-mli-nothing-permanent-about-it#gs.diHe_Bc> accessed 21 October 2018

²⁷⁰ Philip Baker and Richard Collier, “2008 OECD Model : changes to the Commentary on Article 7 and the attribution of profits to permanent establishments” [2009] 63(5) *Bulletin for International Taxation* 201

²⁷¹ Aneta Majchrowicz-Bączyk, “Appointment of a sales representative vs. risk of permanent establishment (Poland)” (Rödl & Partner, 2018) <http://www.roedl.net/pl/en/hot_news/appointment_of_a_sales_representative_vs_risk_of_permanent_establishment.html> accessed 21 October 2018

²⁷² “BEPS Public Consultation: Preventing the Artificial Avoidance of PE Status. Revised Discussion Draft” (OECD, 15 May 2015 – 12 June 2015) 9 <<http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-7-pe-status.pdf>> accessed 21 October 2018

the boundary is extended beyond a single legal entity to cover activities of agent as another entity.²⁷³

Exploring the history of dependent agent PE concept will allow us to understand its rationale in more detail. Agent PE concept originated in the 19th century, when by an agent one could consider a travelling salesman or a local representative of a foreign manufacturer, entrusted to conclude orders from firm customers in the host state.²⁷⁴ Originally, agent PE provision was introduced to avoid “manipulations” by the taxpayers and at the same time to ensure fiscal neutrality to economically similar situations (e.g. market penetration in the source state).²⁷⁵ At the 1920 Brussels Financial Conference, double taxation was recognised as the “major obstacle to the reconstruction of the public finance of the world”.²⁷⁶ In 1927 and 1928 the League of Nations formulated the original model treaties that still left two questions open – where and when did dependent agent constitute PE, and how to calculate PE profits.²⁷⁷ As a summary of the developments before OECD Draft (1963), the “bona fide agent of independent status (broker, commission agent, etc.)” did not amount to a PE. Real legal and economic independence was required for an agent not to fall under PE scope.²⁷⁸

Agent PE concept has been defined in Article 5 of the OECD Model Tax Convention since first 1963 edition, without significant changes over numerous editions.²⁷⁹ Dependent agent PE concept development reflects the trend of replacing facility-oriented approach to PE with an activity-oriented approach that focuses on deemed PEs constituted by human activities.²⁸⁰ This way, OECD 1963 model and its Commentary views dependent agents as a separate type of PE as it does not by any means refer to “place of business” of the

²⁷³ Richard Vann, “Tax Treaties: The Secret Agent's Secrets” [2006] 50(3) British Tax Review 359

²⁷⁴ Philip Baker QC, “Dependent Agent Permanent Establishments: Recent OECD Trends” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 24

²⁷⁵ Raffaele Petrucci, “The Dependent Agent Permanent Establishment as an Extension of the Permanent Establishment Concept of Article 5(1) of the OECD Model Convention” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 45

²⁷⁶ Claus Staringer and Felipe Vallada “Acting in the ordinary course of business under Article 5(6) of the OECD Model Convention” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 186

²⁷⁷ Richard Vann, “Tax Treaties: The Secret Agent's Secrets” [2006] 50(3) British Tax Review 358

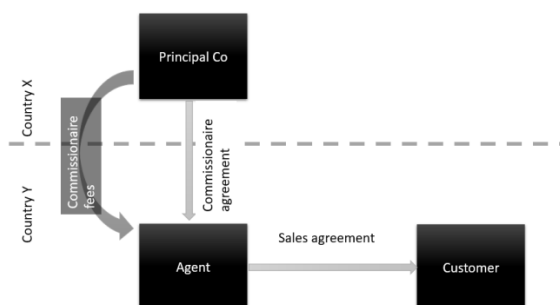
²⁷⁸ Hans Pijl, “Agency Permanent Establishments: in the name of and the Relationship between Article 5(5) and (6) – Part 2” [2013] 2 Bulletin for International Taxation 85

²⁷⁹ Raffaele Petrucci, “The Dependent Agent Permanent Establishment as an Extension of the Permanent Establishment Concept of Article 5(1) of the OECD Model Convention” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 36

²⁸⁰ Reimer, Ekkehart, Stefan Schmid, and Marianne Orell, *Permanent Establishments: A Domestic Taxation, Bilateral Tax Treaty and OECD Perspective* (5th edn, Kluwer Law International, 2016) OECD MC - 101

agent.²⁸¹ It means that already at that time the agent did not have to use a place of business to constitute the agency PE.²⁸² It shows that dependent agency PE emerged as a separate type of PE a long time ago.

As already discussed in chapter 2, globalisation inevitably makes business models and value chains more complex and strengthen the will of tax authorities to counter tax avoidance schemes. OECD has frequently discussed the division of supply chains of MNEs.²⁸³ It has been clear since long the start of the BEPS project that the OECD aspired to change the dependent agent rule terms due to concerns about commissionaire and similar arrangements.²⁸⁴ A commissionaire agreement is an arrangement where a person sells products in a given country in its own name, but on behalf of a foreign entity owning these products (see Chart 6).²⁸⁵ These arrangements fell out the scope of the rule in previous editions.²⁸⁶ Commissionaire arrangements allowed taxpayers to shift risks, assets and profits of local distributors to low-tax jurisdictions where the principal was located.²⁸⁷ Changes brought by BEPS Action 7 to OECD Model Tax Convention lowered PE threshold in a way that can trigger PE in case of commissionaire agreements.



²⁸¹ Arvid Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle (Kluwer Law International, 1991) 97

²⁸² Arvid Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle (Kluwer Law International, 1991) 97

²⁸³ Michael Lang et al, The OECD-Model-Convention and Its Update 2014 (Linde Verlag, 2015) 255

²⁸⁴ Dean Kern et al, “Revamped dependent agent rule a marked change in the OECD’s final BEPS permanent establishment Report will affect the ME region” (PwC, November 2015)

<<https://www.pwc.com/m1/en/tax/documents/2015/beps-revamped-dependentagent-rule-will-affect-me-region.pdf>> accessed 21 October 2018

²⁸⁵ Preventing the Artificial Avoidance of Permanent Establishment Status – Action 7: Final Report, Introductory Notes (OECD Publishing, 2015) 15 < <https://doi.org/10.1787/9789264241220-en>> accessed 21 October 2018

²⁸⁶ Dean Kern et al, “Revamped dependent agent rule a marked change in the OECD’s final BEPS permanent establishment Report will affect the ME region” (PwC, November 2015)

<<https://www.pwc.com/m1/en/tax/documents/2015/beps-revamped-dependentagent-rule-will-affect-me-region.pdf>> accessed 21 October 2018

²⁸⁷ Piotr Drobniak, “The Attribution of Profits to a Dependent Agent PE – If the Dependent Agent Is a Commissionaire (Wholly Owned Subsidiary) of the Principal” [2018] 25(3) International Transfer Pricing Journal 197

Chart 5. Commissionaire agreement²⁸⁸

BEPS Action 7 also explored similar tax avoidance strategies, such as contracts which are substantially negotiated in one state but finalised or authorised abroad, as well as cases where the person habitually exercising an authority to conclude contracts constitutes an “independent agent”.²⁸⁹

All in all, tightening regulation of agent PEs to tackle commissionaire agreement resulted in lowering the PE threshold (Article 5(5) of OECD Model Tax Convention) and narrowing down criteria for agent independence (Article 5(6) of OECD Model Tax Convention).²⁹⁰

4.3. Current provisions on dependent agent PE under Article 5(5) of OECD Model Tax Convention

Definition of an agency PE in the OECD Model Tax Convention is one of the longest in tax treaties ever.²⁹¹ The relatively narrow scope of definition stated in Article 5(5) of OECD Model has prompted tax planning. Namely, enterprises started to replace traditional distributor arrangements by “commissionaire arrangements” which resulted in shifting profits out of the country where the sales take place without changing the functions in that country substantively, as well as efforts to artificially fragment operations among several entities to fall under exception for preparatory and ancillary activities.²⁹² As a result, BEPS Action 7 required a policy re-evaluation of existing PE concept in relation to commissionaire arrangements. The BEPS initiative’s Focus Group on the Artificial Avoidance of PE Status is strongly convinced that legal structures should follow the “real

²⁸⁸ Permanent establishments: Recent trends and developments (EY, 2015) 10
<[https://www.ey.com/Publication/vwLUAssets/ey-permanent-establishments/\\$FILE/ey-permanent-establishments.pdf](https://www.ey.com/Publication/vwLUAssets/ey-permanent-establishments/$FILE/ey-permanent-establishments.pdf)> accessed 20 October 2018

²⁸⁹ Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report (OECD, 2015) 15 <<https://www.oecd-ilibrary.org/docserver/9789264241220-en.pdf>> accessed 21 October 2015

²⁹⁰ Permanent establishments: Recent trends and developments (EY, 2015) 8
<[https://www.ey.com/Publication/vwLUAssets/ey-permanent-establishments/\\$FILE/ey-permanent-establishments.pdf](https://www.ey.com/Publication/vwLUAssets/ey-permanent-establishments/$FILE/ey-permanent-establishments.pdf)> accessed 20 October 2018

²⁹¹ Hans Pijl, “Agency Permanent Establishments: in the name of and the Relationship between Article 5(5) and (6) – Part 1” [2013] 1 Bulletin for International Taxation 3

²⁹² “BEPS Public Consultation: Preventing the Artificial Avoidance of PE Status. Revised Discussion Draft” (OECD, 15 May 2015 – 12 June 2015) 9 <<http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-7-pe-status.pdf>> accessed 21 October 2018

world” facts, one of its goals is to aggressively combat tax structures where legal reality does not match facts.²⁹³

Report on Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status) resulted in changes to Article 5(5) of OECD Model Tax Convention. Updated provision states that

“Where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts or **habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise...** The enterprise shall be deemed to have a permanent establishment in that state”

In other words, dependent agent PE is created when an enterprise residing in a contracting state becomes taxable in another host country on its business profit, if this enterprise is represented by an agent in the host country, who has and habitually exercises an authority to conclude the contract.²⁹⁴ Objective of revised Article 5(5) is to cover situations when a contract is substantially negotiated in one country, but approved or finalised outside this country.²⁹⁵ Before this revision of Article 5(5), actual conclusion of contracts was required to trigger PE – now the scope is wider.

There is a reason why the first chapter was fully dedicated to analysis of general PE concept. The general definition under Article 5 “sets a standard for the entire convention”, so it will be relevant also for all other provisions of OECD Model Tax Convention referring to the general concept.²⁹⁶ However, to map risks specific to dependent agent PE, it is important to identify key risk elements present in definition of dependent agent PE. In this context, by risk elements, I mean key characteristics of dependent agent based on wording of Article 5(5), that allow to assess the presence of dependent agent PE on the case-by-case basis.

²⁹³ Arthur Pleijssier, “The Artificial Avoidance of Permanent Establishment Status: A Reaction to the BEPS Action 7 Final Report” [2016] 11/12 International Transfer Pricing Journal 442

²⁹⁴ Jitendra Jain, “Dependent Agent Permanent Establishment After MLI... Nothing Permanent About It” (BloombergQuintOpinion, 6 August 2017) <<https://www.bloombergquint.com/opinion/dependent-agent-permanent-establishment-after-mli-nothing-permanent-about-it#gs.bLnJr4Q>> accessed 21 October 2018

²⁹⁵ Jitendra Jain, “Dependent Agent Permanent Establishment After MLI... Nothing Permanent About It” (BloombergQuintOpinion, 6 August 2017) <<https://www.bloombergquint.com/opinion/dependent-agent-permanent-establishment-after-mli-nothing-permanent-about-it#gs.bLnJr4Q>> accessed 21 October 2018

²⁹⁶ Raffaele Petrucci, “The Dependent Agent Permanent Establishment as an Extension of the Permanent Establishment Concept of Article 5(1) of the OECD Model Convention” 42 in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) citing Klaus Vogel, *Klaus Vogel on double taxation conventions: a commentary to the OECD-, UN-, and US model conventions for the avoidance of double taxation on income and capital, with particular reference to German treaty practice* (Kluwer Law International, 1997) 282

4.4. PE risk identification: key risk elements of OECD Model Tax provisions

In this part, I would go through the compound elements of dependent agent PE definition (see Chart 6), that in its turn will allow to assess, prioritise and analyse risks arising from distributor activities.

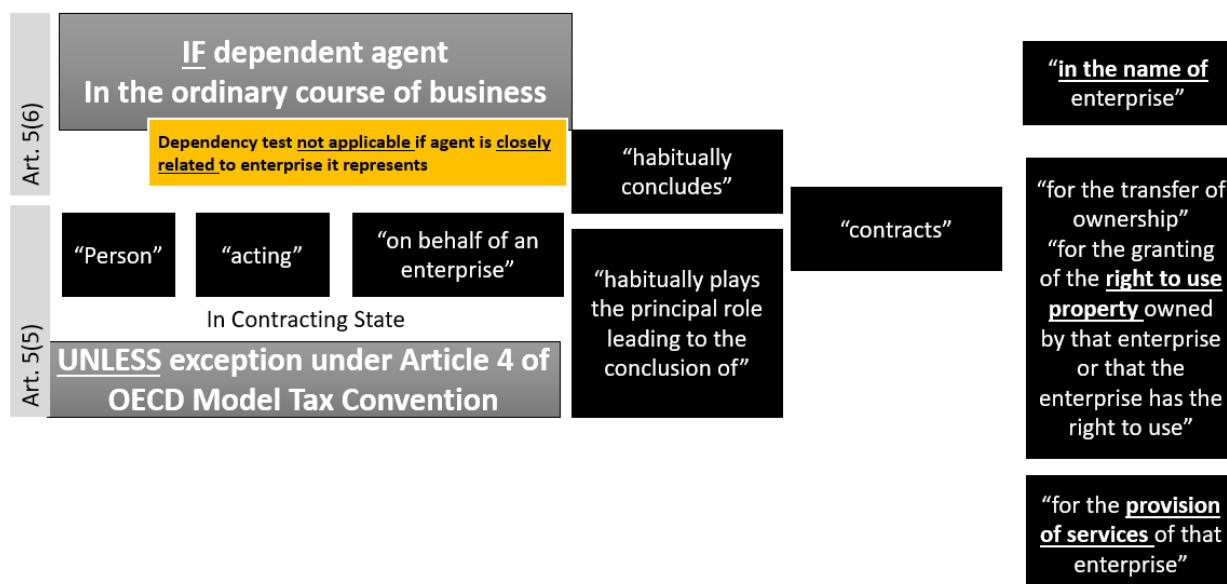


Chart 6. Key compounds (risk elements) of dependent agent PE concept under Article 5(5) of OECD Model Tax Convention

4.4.1. “Person”

The term “person” is defined in Art. 3 para. 1 letter a) OECD Model and includes individuals, companies and any other bodies of persons, such as partnerships, foundations and other legal forms as long as they are either corporate bodies for tax purposes (i.e. companies) or constitute other bodies of persons.²⁹⁷ Persons who can create an agency PE do not need to reside in the State in which they act or to maintain a place of business in that State.²⁹⁸²⁹⁹ It is also irrelevant whether the person has limited or unlimited tax liability in that State, or is found to be an agent under the applicable domestic law.³⁰⁰³⁰¹ In other

²⁹⁷ David Feuerstein, “The Agency Permanent Establishment” in Florian Brugger and Patrick Plansky (eds), *Permanent Establishments in International and EU Tax Law* (Linde Verlag, 2011) 110

²⁹⁸ David Feuerstein, “The Agency Permanent Establishment” in Florian Brugger and Patrick Plansky (eds), *Permanent Establishments in International and EU Tax Law* (Linde Verlag, 2011) 110

²⁹⁹ 2017 OECD Model Tax Convention on Income and On Capital 141 (Commentary to Article 5, Para 83)

³⁰⁰ David Feuerstein, “The Agency Permanent Establishment” in Florian Brugger and Patrick Plansky (eds), *Permanent Establishments in International and EU Tax Law* (Linde Verlag, 2011) 110

³⁰¹ 2017 OECD Model Tax Convention on Income and On Capital 141 (Commentary to Article 5, Para 83)

words, in case of dependent agent PE, “personal connection test” replaces “location test”.³⁰²

4.4.2. “Acting”

Article 5(5) does not specify whether the activity is restricted to certain types of business activities, meaning that potentially Article 5(5) will cover any business activity. Exception would be a mere passive representation in a state.³⁰³ Most likely, activities that fall under the scope of Article 5(5) are activities, which due to “scope of their authority” and the “nature of their activity”, involve the enterprise in sales-related business activities in the state concerned.³⁰⁴

4.4.3. “On behalf of an enterprise”

Person is not acting on behalf of the other enterprises, when person concludes contracts on its own behalf and to perform obligations arising from these contracts, e.g. in cases of low-risk distribution.³⁰⁵ Thus, in case of low-risk distribution there are no concerns of PE risk, but BEPS addresses it from the perspective of the transfer pricing of risks and capital.³⁰⁶ Namely, there can be a case of aggressive tax planning when title to the goods is transferred from the principal to the agent (“flash title”).³⁰⁷

However, linguistic peculiarities and specifics of legal systems may impact interpretation of this criterion. “*Pour le compte*” used in the official French version of the OECD Model can be translated as “on behalf of” but also “for the account of”. This indicates that the concept of “on behalf” can have both legal and economic perspectives.³⁰⁸ We will analyse it further when looking into the concept of contracts “in the name of enterprise”, as these notions are interconnected.

³⁰² Arvid Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle (Kluwer Law International, 1991) 464

³⁰³ Alfred Storck and Sabine Schmidjell-Dommes, “Acting on Behalf of an Enterprise under Article 5(5) of the OECD Model Convention” in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 51

³⁰⁴ Alfred Storck and Sabine Schmidjell-Dommes, “Acting on Behalf of an Enterprise under Article 5(5) of the OECD Model Convention” in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 82

³⁰⁵ 2017 OECD Model Tax Convention on Income and On Capital 145 (Commentary to Article 5, Para 96)

³⁰⁶ BEPS Action 7: Preventing the artificial avoidance of permanent establishment status (Deloitte, 20 May 2015) 2 <<https://www2.deloitte.com/content/dam/Deloitte/ca/Documents/tax/ca-en-itsl-beps-action-7-preventing-the-artificial-avoidance-of-PE.pdf>> accessed 21 October 2018

³⁰⁷ Alfred Storck and Raffaele Petruzzi, “Permanent Establishments: Proposals Related to Agency Permanent Establishments – Article 5(5) and (6) of the OECD Model Convention” in Michael Lang et al (eds), *Base Erosion and Profit Shifting (BEPS)* (Linde Verlag, 2016) 103-104

³⁰⁸ Alfred Storck and Sabine Schmidjell-Dommes, “Acting on Behalf of an Enterprise under Article 5(5) of the OECD Model Convention” in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 54

4.4.4. Habitual conclusion or principal role leading to the conclusion of contracts

Habitually. Already before the BEPS, tax authorities were increasingly asserting that PE exists in case of a local commissionaire habitually entering into contracts binding on the foreign Principal, even if those contracts were not in the name of that Principal.³⁰⁹ However, this trend does not mean that habitualness criterion is predictable. Even though habitual exercise of authority is the key factor in identifying agency PE, there is no standard definition of “habitually”.³¹⁰ Thorough case-by-case analysis should consider the usual lifecycles of the contracts concluded and their relation to overall business model and activities.³¹¹ Habitual exercise of authority to conclude contracts can be determined based on following criteria:

- (1) actual exercise of authority;
- (2) frequency; and
- (3) a certain degree of permanence (exceeding transitory presence).³¹²

Broad and ambiguous language increases a risk of accidental identification of PE, e.g. in case when a commission agent, a top-notch salesperson is acting more actively than expected, and this results in conclusion of contract.³¹³ It makes habitualness criterion one of the riskiest among those I analysed so far.

Conclusion of contracts. Signing of the contract is not the principal criterium of concluding the contract. It is well established that signing by “another person” who is different from the agent does not affect determination of agency PE if the signing does not

³⁰⁹ Lifting the mist: Sustainable distribution models in the post-BEPS world (EYGM Limited, 2017) 3
<[https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/\\$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf](https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf)> accessed 21 October 2018

³¹⁰ Pasquale Pistone and César Alejandro Ruiz Jiménez, “Habitual Exercise of Authority to Conclude Contracts under Article 5 (5) of the OECD Model Convention” in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 157

³¹¹ David Feuerstein, “The Agency Permanent Establishment” in Florian Brugger and Patrick Plansky (eds), *Permanent Establishments in International and EU Tax Law* (Linde Verlag, 2011) 116

³¹² Pasquale Pistone and César Alejandro Ruiz Jiménez, “Habitual Exercise of Authority to Conclude Contracts under Article 5 (5) of the OECD Model Convention” in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 137

³¹³ David Forst and William Skinner, “Tax Alert: Commissionaires and Other PE Structures under Scrutiny as Part of BEPS” (Fenwick & West LLP, 8 December 2014)
<<https://www.fenwick.com/publications/pages/tax-alert-commissionaires-and-other-pe-structures-under-scrutiny-as-part-of-beps.aspx>> accessed 23 October 2018

have any material influence on the obligations under previously negotiated contracts.³¹⁴ Sometimes there is no active negotiation of contractual terms before conclusion of contract, for example, in case of acceptance of the offer to enter into a standard contract, even if the actual signing happened outside the state.³¹⁵ Also, negotiation of all element of details of a contract in a way binding the enterprise amounts to the conclusion of the contract, even if signing took place in another state.³¹⁶

Principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. Previously, OECD Model Tax Convention covered only conclusion of the contracts. However, historically, some OECD member countries focused on “literally” signing contracts in the name of the principal whereas other interpreted it in a more broader way as requiring a legally or even economically binding authority.³¹⁷

Adding this new criterium widens the PE threshold by moving the focus from the formal authority to conclude contracts to the actual substance of activities of the agent. BEPS Action 7 incentivised amendment of dependent agent PE to combat against the artificial use of commissionaire structures and offshore rubber-stamping arrangements. For example, in some tax avoidance arrangements, an automated system managed overseas by the parent company could be responsible for the finalisation of these contracts.³¹⁸ Amendments to OECD have ensured that such tax avoidance schemes will trigger PE status.

Goal of this criterion is to cover cases when the conclusion of contract directly results from the actions performed in a Contracting state, even if applicable law does not deem the contract concluded exactly in the State.³¹⁹ This is common for the sales force models when person solicits and receives orders sent directly to a warehouse after routine approval by the enterprise.³²⁰ For example, if such approvals or reviews happen outside the State without modifying key aspects of the contract, the criterion of “principal role” of the agent

³¹⁴ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 489

³¹⁵ 2017 OECD Model Tax Convention on Income and On Capital 242 (Commentary to Article 5, Para 87)

³¹⁶ 2017 OECD Model Tax Convention on Income and On Capital 242 (Commentary to Article 5, Para 87)

³¹⁷ Alfred Storck and Sabine Schmidjell-Dommes, “Acting on Behalf of an Enterprise under Article 5(5) of the OECD Model Convention” in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 57

³¹⁸ OECD, *Tax Challenges Arising from Digitalisation – Interim Report 2018: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project* (OECD Publishing, 2018) 94
<<https://doi.org/10.1787/9789264293083-en>> accessed 20 October 2018

³¹⁹ 2017 OECD Model Tax Convention on Income and On Capital 242 (Commentary to Article 5, Para 88)

³²⁰ 2017 OECD Model Tax Convention on Income and On Capital 243 (Commentary to Article 5, Para 88)

is satisfied.³²¹ This addition to Article 5 wording literally places any sales agent under the scope of dependent PE concept. For instance, it may penalise a sale agent who is good at job and thus is doing a great job in negotiating contracts that would not require any changes by the enterprise.³²² It is possible to get into a safe zone where local personnel may be involved in significant solicitation and even negotiations in the source state,

In light of the complexity with which agency activities are defined, MNEs should carefully analyse examples provided in OECD Model to decide whether to restructure their sales organization.³²³ Commentary separates two examples. "Merely" promoting and marketing goods would not trigger PE status. There, OECD provides an example of active promotion of drugs by pharmaceutical representatives that does not directly result in doctors concluding the agreements with the enterprise. However, immediately OECD provides two other examples. Namely, under its text, there is PE when the agent solicits and receives orders sent directly to "warehouse from which goods belonging to the enterprise are delivered" warehouse without their formal finalisation (formal finalisation is carried through routine approvals by the enterprise). Also, employees of the enterprise actively explaining standard terms of the contract that lead to subsequent conclusion of the contract online fall under scope of agency that triggers PE.³²⁴ These examples show the determination of OECD to look into substance of business arrangements and cover tax avoidance arrangements that MNEs could get away with under previous PE threshold. Also, these cases allow to understand what "without material modification" means in practice, namely, cases of routine approvals of signing. However, explaining the concepts of "principal role" through examples creates the field for uncertainty.

4.4.5 Contracts

It is vitally important to explore what exactly contracts fall under the scope of dependent agent PE. To do it, I should start with key characteristics breakdown. Under Article 5(5) of OECD Model Tax Convention, following types of contracts concluded or actively negotiated by agent can trigger determination of PE:

- "in the name of enterprise"

³²¹ 2017 OECD Model Tax Convention on Income and On Capital 243 (Commentary to Article 5, Para 88)

³²² Arthur Pleijsier, "The Artificial Avoidance of Permanent Establishment Status: A Reaction to the BEPS Action 7 Final Report" [2016] 11/12 International Transfer Pricing Journal 443

³²³ Gary Sprague, "Playing the Principal Role in Creating a Permanent Establishment" (International Tax, 6 January 2016) <<https://www.bna.com/playing-principal-role-n57982065804/>> accessed 4 November 2018

³²⁴ 2017 OECD Model Tax Convention on Income and On Capital 143 (Commentary to Article 5, Paras 89-90)

- “for the transfer of ownership”, or “for the granting of the right to use property owned by that enterprise or that the enterprise has the right to use”
- “for the provision of services of that enterprise”.

First, I would like to start with the classic approach to the scope of dependent agent PE, covering **contracts concluded “in the name of enterprise”**. Contracts include not only contracts for the sale of goods, but also other types of contracts, such as leasing contracts.³²⁵ Term “in the name of” comes from the technical vocabulary of civil law where it determines “whether foreign enterprise or the intermediary is bounded by the contract concluded with the third party”.³²⁶ This term has no meaning in common law. It shows the danger of assuming that one legal system has a universal application.³²⁷ According to some reports, PE can be rendered even when the contract is neither “in the name of” the principal nor legally “binding” on the principal, but rather agent involves the foreign enterprise “to a large extent in the local economy”.³²⁸ Whether a contract concluded by the intermediary legally binds the enterprise is defined by the domestic commercial laws which govern the agency contract.³²⁹

Terms “on behalf of” and “in the name of” have a certain level of linguistic vagueness. Most likely, at the moment of drafting, they meant “binding”.³³⁰ In law and practice, there are two approaches to defining what “binding” means, as shown below.

Table 5. Economic and legalistic approaches to interpretation of “in the name of”³³¹

Approach	Economic approach	Legalistic approach
Main concept	Legal binding force of contract is not decisive, active participation in negotiating contract and securing legal	“In the name of” requires contracts that legally binds the principal towards the third party

³²⁵ Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention (OECD, 12 October 2011 to 10 February 2012) 38
<<http://www.oecd.org/tax/treaties/48836726.pdf>> accessed 9 November 2018

³²⁶ David Feuerstein, “The Agency Permanent Establishment” in Florian Brugger and Patrick Plansky (eds), *Permanent Establishments in International and EU Tax Law* (Linde Verlag, 2011) 113

³²⁷ Avery Jones, “The Origins of Articles 5(5) and 5(6) of the Model” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 7

³²⁸ Hans Pijl, “Agency Permanent Establishments: in the name of and the Relationship between Article 5(5) and (6) – Part 1” [2013] 1 Bulletin for International Taxation 6

³²⁹ David Feuerstein, “The Agency Permanent Establishment” in Florian Brugger and Patrick Plansky (eds), *Permanent Establishments in International and EU Tax Law* (Linde Verlag, 2011) 124

³³⁰ Hans Pijl, “Agency Permanent Establishments: in the name of and the Relationship between Article 5(5) and (6) – Part 1” [2013] 1 Bulletin for International Taxation 13

³³¹ Paolo Ruggiero, “New guidance on permanent establishments – practical considerations & recent tax disputes” (Taxand, 16 November 2017) <<https://www.taxand.com/wp-content/uploads/2017/11/New-OECD-guidance-on-Permanent-Establishments-2017-Taxand-TP-Conference.pdf>> accessed 23 October 2018

	arrangements can amount to required “economic link” in the source state	
Agency scope	Agency relationship, both direct and indirect, binds the principal towards the third party	Not every dependent agent will lead to an agency PE – one should distinguish between direct and indirect representation
Case law	Phillippe Morris case	Zimmer, Dell, Boston Scientific cases

The tax authorities favouring economic approach to “authority to conclude contracts in the name of the enterprise” all lost in their cases before the respective supreme courts.³³² It is predictable, as they aim to increase their tax revenue. As noted already during discussion on Article 5 back in 2013, national courts lack a common stance on whether possession of “authority” implies a valid legal relationship with a third party or whether an economic commitment of a principal by its agent will suffice.³³³ Namely, in cases Zimmer, Dell, Boston Scientific, respective supreme courts ruled that a commissionaire acting in his own name and under the applicable law of a state that does not legally bind the principal, does not constitute a PE.³³⁴ It means that “binding” is to be interpreted in legal sense only, but not from economic/commercial perspective.³³⁵ In view of the historical analysis of the agency clause and its connection with the independent agent provision contained in article 5(6), it seems reasonable to understand agency as “concluding contracts legally binding the enterprise in relations with the third party”.³³⁶ However, some still argue that “in the name of” is too narrow criterion to cover MNE fragmented distribution chains and it should be widened to ensure that commercial dependence between the agent and its principal is captured.³³⁷ However, I believe that such proposals would bring even more uncertainty. Already now, taxpayers are under risk to find that the same agreement can give rise to a

³³² Katharina Daxkobler, “Authority to Conclude Contracts in the Name of the Enterprise” in in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 120

³³³ ICC comments on “Revised proposals concerning the interpretation and application of Article 5 (Permanent Establishment)” (ICC, 2013) 4 <<http://www.oecd.org/ctp/treaties/PERMESTICC.pdf>> accessed 9 November 2018

³³⁴ Hans Pijl, “Agency Permanent Establishments: in the name of and the Relationship between Article 5(5) and (6) – Part 1” [2013] 1 Bulletin for International Taxation 6

³³⁵ Hans Pijl, “Agency Permanent Establishments: in the name of and the Relationship between Article 5(5) and (6) – Part 1” [2013] 1 Bulletin for International Taxation 6

³³⁶ Katharina Daxkobler, “Authority to Conclude Contracts in the Name of the Enterprise” in in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 130

³³⁷ Alfred Storck and Alexander Zeiler, “Lang et al (Eds), The OECD-Model-Convention and its Update 2014 241 Beyond the OECD Update 2014: Changes to the Concepts of Permanent Establishments in the Light of the BEPS Discussion” in Michael Lang et al (eds), *The OECD-Model-Convention and Its Update 2014* (Linde Verlag, 2014) 262

very different tax treatment in different countries due to conflict of laws.³³⁸ Thus, it is likely that in practice tax authorities would focus more on exploring whether agency relationship satisfies the criterion of concluding contracts or playing principal role in it.

In addition to agreements on provision of services, agents may also conclude the agreements triggering the **transfer of ownership or the right to use property**. This definition covers commissionaire agreements since the goal of the contract is to transfer the ownership of the property owned by a foreign enterprise even if that foreign enterprise is not a party to that contract.³³⁹ It does not matter whether property in question existed or was owned by the enterprise when the contract between the commissionaire and the third parties was concluded, as contracts may cover delivery of the tangible or intangible goods that will be produced later.³⁴⁰

Analysis of “contract” term has shown that it may be a significant source of uncertainty for MNEs functioning cross-borders due to specifics of legal systems and differing approaches of tax authorities and courts in interpreting binding force. Namely, BIAC (Business at OECD) have noticed that lack of consensus on interpretation of contracts due to OECD not preferring expressed view on this point allows dissenting members to record their disagreements through observations.³⁴¹ Concept of agency that I will explore next also has the similar uncertainty effect.

4.4.6. Independent agent in the ordinary course of business

Agent. Under Article 5(6) of OECD Model, Article 5 (5) shall not apply

“where the person acting in a Contracting state on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as independent agent and acts for the enterprise **in the ordinary course of business**”³⁴².

For this reason, it is important to define what OECD Model Tax Convention means by “agent” and what agent would be considered “independent”. Article 5(6) OECD Model

³³⁸ Jonathan Schwarz, “Agency Permanent Establishments: Commissionaires in the frame” (Kluwer International Tax Blog, 16 December 2015) <<http://kluwertaxblog.com/2015/12/16/agency-permanent-establishments-commissionaires-in-the-frame/>> accessed 23 October 2018

³³⁹ “BEPS Public Consultation: Preventing the Artificial Avoidance of PE Status. Revised Discussion Draft” (OECD, 15 May 2015 – 12 June 2015) 12 <<http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-7-pe-status.pdf>> accessed 21 October 2018

³⁴⁰ 2017 OECD Model Tax Convention on Income and On Capital 145 (Commentary to Article 5, Para 95)

³⁴¹ BIAC response to the OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment) (BIAC, 31 January 2013) 9 <<http://www.oecd.org/ctp/treaties/PERMESTBIAC.pdf>> accessed 9 November 2018

³⁴² Bold font added by author of thesis.

Tax Convention 2010 had a more detailed listing of types of agents rather than simply stating referring to ordinary course of business:

“An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State **through a broker, general commission agent or any other agent of an independent status,** provided that such persons are acting **in the ordinary course of their business**”.³⁴³

The more general reference to “agent” makes implementation of Article 5(6) more flexible, especially in reality of really different legal systems. Concept should focus on the manner in which the agent conducts his business activities in a broader sense.³⁴⁴ Domestic laws play an important role in shedding some light what agent is and what is his business functions.³⁴⁵ Namely, domestic law of a few countries, in particular Germany and the UK, influenced the terminology chosen in the OECD model.³⁴⁶ Working Group on Article 5 has for a long time pointed out that “general commission agent” used in the English version of OECD Model does not correspond with term “commissionaire” that appears in French version.³⁴⁷

To be more specific, there is a difference between civil law and common law approaches to agency concept. Namely, the UK law defines following types of representation:

- “Direct where they act in the name of and on behalf of another person
- Indirect where they act in their own name but on behalf of another person
- Self-representation when a person acts on their own behalf.”³⁴⁸

A person who is not “truly represent” of the principal in this manner – like the indirect representative under civil law – is not regarded as an “agent” under common law.³⁴⁹ It

³⁴³ Underlining added by author of the thesis.

³⁴⁴ Fuentes Hernández, “Agents of an Independent Character” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 174

³⁴⁵ Fuentes Hernández, “Agents of an Independent Character” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 174

³⁴⁶ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 506

³⁴⁷ Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention (OECD, 12 October 2011 to 10 February 2012) 39
<<http://www.oecd.org/tax/treaties/48836726.pdf>> accessed 9 November 2018

³⁴⁸ HMRC internal manual, Import and National Clearance Hub Procedures (HM Revenue & Customs, 30 June 2016) <<https://www.gov.uk/hmrc-internal-manuals/import-and-national-clearance-hub-procedures/inchp02060>> accessed 23 October 2018

³⁴⁹ Katharina Daxkobler, “Authority to Conclude Contracts in the Name of the Enterprise” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 89 citing Guiseppe Persico, Agency Permanent Establishment under Article 5 of the OECD Model Convention [2002] 28(2) Intertax 66-68

means that the civil law notion of “agency” is broader than in common law, encompassing both direct and indirect representation.³⁵⁰

Independent. Generally, an agent is dependent, if the business interests of the principal and the agent have merged.³⁵¹ Independent agent is independent both legally and economically. From legal perspective, important criteria are “detailed instructions” and “comprehensive control”.³⁵² Economic independence may be defined by the number of principals for which an agent acts and the level of entrepreneurial risk.³⁵³ The more principals an agent engages with, the more likely it is that we deal with independent agent.³⁵⁴ An independent agent also typically bears the risk of losses for his activities.³⁵⁵ Commentary to OECD Model lists a number of criterion that may (“relevant criteria”) or may not (“insufficient criteria”) trigger PE status:

Table 6. Dependence test criteria under OECD Model Tax Convention

Relevant criteria	Insufficient criteria (if applied independently)
<ul style="list-style-type: none"> • “obligations vis-à-vis enterprise” (OECD, Commentary to Article 5, Para 103) • “detailed instructions” (OECD, Commentary to Article 5, Para 103) • “comprehensive controls” (OECD, Commentary to Article 5, Para 103) • Burden of “entrepreneurial risk” • “Comprehensive control” • “Number of principals represented by the agent” (OECD, Commentary 	<ul style="list-style-type: none"> • “Limitations on scope of business” (OECD, Commentary to Article 5, Para 107) • “substantial information ... in connection with the business” (OECD, Commentary to Article 5, Para 108)

³⁵⁰ Katharina Daxkobler, “Authority to Conclude Contracts in the Name of the Enterprise” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 89 citing Guiseppe Persico, Agency Permanent Establishment under Article 5 of the OECD Model Convention [2002] 28(2) Intertax 66-69

³⁵¹ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 513

³⁵² Josef Schuch and Eline Huisman Lang, “The Dependent Agent PE under Article 5(5), (6) and (7) of the UN Model Convention” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 281-282

³⁵³ Josef Schuch and Eline Huisman Lang, “The Dependent Agent PE under Article 5(5), (6) and (7) of the UN Model Convention” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 282

³⁵⁴ Josef Schuch and Eline Huisman Lang, “The Dependent Agent PE under Article 5(5), (6) and (7) of the UN Model Convention” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 283 citing Robert Williams and John Huston, *Permanent Establishments: A Planning Primer* (Kluwer 1993) 134

³⁵⁵ Josef Schuch and Eline Huisman Lang, “The Dependent Agent PE under Article 5(5), (6) and (7) of the UN Model Convention” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 283

Extent of the obligations regarding the enterprise and distribution of entrepreneurial risk between the enterprise and the agent are key determinants of whether agent is dependent.³⁵⁶ If an agent represents an independent enterprise, activities of this agent should not result in rendering it a PE.³⁵⁷ If commercial activities of the agent are regulated by detailed instructions or fall under comprehensive control of the enterprise, we deal with dependent agent.³⁵⁸ Independent agent, in contrast, is responsible for the agency results, but is not bound by strict regulations from the side of enterprise.³⁵⁹ Limitations of scale of business normally would not fall under the concept of enterprise control and thus will not affect the dependency test.³⁶⁰ It is also important to remember that dependent agency risk overlaps significantly with increasing employee mobility risks. Namely, an employee acting on behalf of the employer entity in role of the employee, or a partner representing partnership are not independent.³⁶¹

Ordinary course of business. OECD Commentaries historically have not provide any detailed clues to what term “ordinary course of business” means.³⁶² While Article 5(5) is fairly useless in common law system, and Article 5(6) is fairly useless in civil law system, together they give a coherent view on dependent agent PE concept, at least as long as “one reads only the version in one’s own language and system of law without asking what it means in another language and system of law”.³⁶³ This concept is based on the assumption that an agent is considered dependent if his activity exactly answers the core of the principal's business.³⁶⁴ Thus the business of the principal might be the standard to which actual activity is compared.³⁶⁵ Intermediation activities indistinguishable from each other

³⁵⁶ 2017 OECD Model Tax Convention on Income and On Capital 147 (Commentary to Article 5, Para 104)

³⁵⁷ 2017 OECD Model Tax Convention on Income and On Capital 146 (Commentary to Article 5, Para 102)

³⁵⁸ 2017 OECD Model Tax Convention on Income and On Capital 147 (Commentary to Article 5, Para 104)

³⁵⁹ 2017 OECD Model Tax Convention on Income and On Capital 147 (Commentary to Article 5, Para 106)

³⁶⁰ 2017 OECD Model Tax Convention on Income and On Capital 147 (Commentary to Article 5, Para 107)

³⁶¹ 2017 OECD Model Tax Convention on Income and On Capital 147 (Commentary to Article 5, Para 103)

³⁶² Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 516

³⁶³ Avery Jones, “The Origins of Articles 5(5) and 5(6) of the Model” in Michael Lang (ed), *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 21

³⁶⁴ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 515

³⁶⁵ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 516

amount to the ordinary course of business.³⁶⁶ Performing activities unrelated to the agency business mean that agent is not acting in the ordinary course of business.³⁶⁷

However, certain questions are left open when it comes to defining impact on dependent agent test for determining PE as shown in matrix below.

Table 7. Dependent agent test uncertainties under revised OECD Model Tax Convention 2017³⁶⁸

		Acting in the ordinary course of business:	
		YES	NO
Legal and economic independence:	YES	NO PE	PE if Article 5(5)?
	NO	PE if Article 5(5)?	PE if Article 5(5)?

Namely, we are facing following questions: “

1. When does an associated enterprise constitute an agency PE?
2. Can an associated enterprise be an independent agent
3. If an associated enterprise constitutes an agency PE; how are profits on an independent enterprise basis to be taxed when two similar rules seem to be applicable, Article 7(2) and Article 9(1)?
4. (Is the result different when an associated enterprise does or does not constitute an agency PE?)³⁶⁹

4.4.7 Special provisions

Finding a PE is impacted by two additional circumstances: whether agent is closely related to the enterprise it represents and whether agent activities can be considered preparatory/auxiliary.

Representation of closely related enterprise. Under updated Article 5(6) of OECD Model Tax Convention an agent should not be rendered independent if it “acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related”.³⁷⁰ This amendment was brought by Action 7 of the OECD/G20 BEPS initiative proposes

³⁶⁶ 2017 OECD Model Tax Convention on Income and On Capital 148 (Commentary to Article 5, Para 110)

³⁶⁷ 2017 OECD Model Tax Convention on Income and On Capital 148 (Commentary to Article 5, Para 110)

³⁶⁸ Paolo Ruggiero, “New guidance on permanent establishments – practical considerations & recent tax disputes” (Taxand, 16 November 2017) <<https://www.taxand.com/wp-content/uploads/2017/11/New-OECD-guidance-on-Permanent-Establishments-2017-Taxand-TP-Conference.pdf>> accessed 23 October 2018

³⁶⁹ Richard Vann, “Tax Treaties: The Secret Agent's Secrets” [2006] 50(3) British Tax Review 347

³⁷⁰ Dinis Tracana, “The Effect of the OECD/G20 BEPS Initiative on the Attribution of Profits to Permanent Establishments: The Special Case of Agency Permanent Establishments” [2017] 71(3/4) Bulletin for International Taxation 215

stricter independence rules. Under Article 15(1) of the MLI, a person is closely related to an enterprise if in light of all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises (50% test). These provisions make it much easier for tax authorities to claim the existence of a PE through dependent agent PE concept.³⁷¹ This will especially affect digital economy activities that do not have physical presence in the source state, for example in case of servers hosting the software.³⁷²

Preparatory/auxiliary activities. From the OECD Model (1977) onward the entire exception clause of article 5(4) of the OECD Model is applicable under article 5(5) of the OECD Model.³⁷³ There is ongoing debate on the need for strict interpretation of the wording of article 5(4) of the OECD Model (1963) or the aim and purpose of the regulation.³⁷⁴ Terms “auxiliary” and “preparatory” constitute the qualitative criterion which determination always depends on the main activities in the enterprise.³⁷⁵ The cumulation of excepted activities does not guarantee the non-PE status if the cumulation of such activities amounts to an essential or significant business activity.³⁷⁶

This analysis shows the general trends to lower PE threshold by narrowing scope where general agency PE rule can apply. MNEs should be prepared for scrutiny of status of closely related enterprise and rigorous assessment of a real economic nature of “preparatory” activities. On a more general level, tax authorities will explore the agency relationship criteria of nature of activity, identity of counterparty and temporal characteristics.³⁷⁷

³⁷¹ Emilien Lebas, “Artificial avoidance of permanent establishment status” (KPMG, 8 February 2017) <<https://home.kpmg.com/xx/en/home/insights/2017/02/artificial-avoidance-of-permanent-establishment-status.html>> accessed 21 October 2018

³⁷² Jonathan Schwartz, “Permanent Establishment: La lutte continue” (Kluwer International Tax Blog, 24 July 2017) <<http://kluwertaxblog.com/2017/07/24/permanent-establishment-la-lutte-continue/?print=print>> accessed 21 October 2018

³⁷³ Nadine Oberbauer, “The Dependent Agent PE and the Exception for Auxiliary and Other Activities under Article 5(4) of the OECD Model Convention” in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 230

³⁷⁴ Nadine Oberbauer, “The Dependent Agent PE and the Exception for Auxiliary and Other Activities under Article 5(4) of the OECD Model Convention” in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 230

³⁷⁵ Nadine Oberbauer, “The Dependent Agent PE and the Exception for Auxiliary and Other Activities under Article 5(4) of the OECD Model Convention” in Michael Lang (ed) *Dependent Agents as Permanent Establishments* (Linde Verlag, 2014) 211

³⁷⁶ Arvid Skaar, *Permanent Establishment: Erosion of a Tax Treaty Principle* (Kluwer Law International, 1991) 295

³⁷⁷ Gary Sprague, “Playing the Principal Role in Creating a Permanent Establishment” (International Tax, 6 January 2016) <<https://www.bna.com/playing-principal-role-n57982065804/>> accessed 4 November 2018

4.5. Dependent agent PE risk ranking, prioritisation and assessment

Amendments to dependent agent PE concept has caused numerous concerns in business environment. For example, European Banking Federation, the united voice of banks established in Europe,³⁷⁸ that the proposals brought by BEPS project show a lack of clear principles or consensus on the interpretation of standards, include vague terms, substantially lower the threshold for what constitutes a PE and can result in increasing amount of tax disputes.³⁷⁹

Also, many large exporting countries are concerned that the expansion of dependent agent PE concept will result in a significant burden for multinationals.³⁸⁰ Due to this, they do not plan to amend their treaties via the Multilateral Convention.³⁸¹ By June 2017, of 68 countries which had signed the MLI, 39 had opted out of the changes to Article 5(5) and 26 had opted out of the Article 5(4) changes altogether.³⁸² However, as the concept of value creation as an allocation principle is present not only in the OECD/G20 BEPS initiative, but also at an EU level,⁵⁵ it is unlikely that it will be withdrawn from international agenda.³⁸³

Stakeholders can only hope that countries will consistently follow the new guidelines for the application of the revised Article 5(4) of OECD Model, otherwise, there is a hope for Action 14, which goal is to make dispute resolution mechanisms more effective.³⁸⁴

However, despite backlash to recent changes both from business community and state representatives, there are certain factors that urge MNEs to prioritise the dependent agent risk in planning their distribution activities. Namely, MNEs can witness evident

³⁷⁸ European Banking Federation <<https://www.linkedin.com/company/european-banking-federation/>> accessed 22 October 2018

³⁷⁹ Marlies de Ruyter, "Comments on the OECD Revised Discussion Draft on BEPS Action 7 "Preventing the Artificial Avoidance of PE Status" (European Banking Federation, 12 June 2015) <https://www.ebf.eu/wp-content/uploads/2017/01/EBF_015322-EBF-Comments-on-OECD-BEPS-Revised-Discussion-Draft-on-PE-Status-Action-7_Final.pdf> accessed 22 October 2018

³⁸⁰ Lifting the mist: Sustainable distribution models in the post-BEPS world (EYGM Limited, 2017) 5 <[https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/\\$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf](https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf)> accessed 21 October 2018

³⁸¹ Lifting the mist: Sustainable distribution models in the post-BEPS world (EYGM Limited, 2017) 5 <[https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/\\$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf](https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf)> accessed 21 October 2018

³⁸² Lifting the mist: Sustainable distribution models in the post-BEPS world (EYGM Limited, 2017) 5 <[https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/\\$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf](https://webforms.ey.com/Publication/vwLUAssets/EY-sustainable-distribution-models-in-the-post-beps-world/$FILE/EY-sustainable-distribution-models-in-the-post-beps-world.pdf)> accessed 21 October 2018

³⁸³ Johanna Hey, "Taxation Where Value is Created" and the OECD/G20 Base Erosion and Profit Shifting Initiative" [2018] 72 (4/5) Bulletin for International taxation 208

³⁸⁴ Stephane Gelin, "The New Permanent Establishment Status after BEPS: Déjà vu in France?" (CMS Tax Connect, 4 August 2016) <<https://cms.law/en/FRA/Publication/The-New-Permanent-Establishment-Status-After-BEPS-Deja-Vu-In-France>> accessed 23 October 2018

determination of OECD and national/supra-national thresholds to lower PE threshold to increase tax revenue especially from well-profitable industries (such as consumer electronics). This research has explored the ongoing work at the level of OECD and the EU to update taxation regime for digital economy.

4.6. Risk analysis

As I explained in chapter 2 on general approach to PE risk management, at risk analysis stage it is important to systematically weigh and group risks arising from PE provisions based on frequency, gravity and consequences of risks.³⁸⁵ Changes enabled by BEPS Action 7 created more ground for subjectivity and uncertainty, thus increasing the risk of disputes between taxpayers and tax administrations.³⁸⁶ Analysis of dependent agent PE concept has helped to identify high-risk situations. Namely, dependent agent PE is likely to be triggered in case of an agent with a low level of entrepreneurial risk, who plays a leading role in concluding agreement in a source state, even if the agreement was formally signed in another state. The primary target will be commissionaire agreements. Low-risk distribution agreements where persons act on their own behalf are on the opposite side of the risk scale as activities unlikely to fall under PE scope. In practice, substance-over-the-form approach may put even limited risk distributors under the scrutiny. Tax authorities are most likely to strictly assess criterion of “habitual conclusion”/“principal role leading to the conclusions of contracts” and explore whether the taxpayers abuse the exceptions to general agency PE rule.

4.7. Risk treatment

Risk analysis has shown that it is becoming more challenging for MNEs to find the right balance between risk management and control in a goal to design a viable operating model.³⁸⁷ From practical perspective, risks treatment stage should empower the stakeholders to identify the different types of dependent agent (PEs) in the post-OECD

³⁸⁵ European Commission Fiscalis Risk Analysis Project Group, *Risk Management Guide for Tax Administrations* (2006) 27

<https://ec.europa.eu/taxation_customs/sites/taxation/files/resources/documents/taxation/tax_cooperation/gen_overview/risk_management_guide_for_tax_administrations_en.pdf> accessed 20 October 2018

³⁸⁶ Alfred Storck and Raffaele Petruzzi, “Permanent Establishments: Proposals Related to Agency Permanent Establishments – Article 5(5) and (6) of the OECD Model Convention” in Michael Lang et al (eds), *Base Erosion and Profit Shifting (BEPS)* (Linde Verlag, 2016) 106

³⁸⁷ Joost Vreeswijk and Ai-Leen Tan, “The impact of BEPS Action 7 on operating models” (International Tax Review, 8 March 2016) <<http://www.internationaltaxreview.com/Article/3535787/The-impact-of-BEPS-Action-7-on-operating-models.html>> accessed 21 October 2018

BEPS environment; compare the pre-BEPS and post-BEPS PE provisions recognise what business activities and structures are affected by new rules.³⁸⁸

Based on tax risk management stages described in chapter 2, tax control framework should aim at:

1. Enhancing communications on provisions regulating dependent agent PE in post-BEPS environment.
2. Enhancing dependent agent PE risk assessment of existing and planned business arrangement.
3. Enhancing tax function role in actual document management.

Next stage will be to identify what key characteristics are necessary for a tax control framework to address PE risk effectively.

4.7.1. PE risk communications across stakeholders

Communications will cover multiple stakeholders, from board of the company, to the agent, himself, to ensure that both parties to the agency relationship have the same understanding of their rights and obligations, and of PE concept. Stakeholder scope in managing PE risk concept includes not only predictably tax function, board, legal and HR departments, but also sales and customer service functions of the enterprise. It means, that communications should be clear, simple and visual enough to fit with competence, schedule and goals of diverse groups. For example, Electrolux Tax Policy clearly states that employees should be guided by the company Code of Conduct and corporate citizenship values also in tax-related questions.³⁸⁹

The starting point of communication is to ensure that dependent agent PE risk is managed in the light of general tax strategy framework aiming at ensuring compliance with corporate social responsibility principles. Communication is especially important because risk management is a team planning in condition of high uncertainty about future markets and regulatory changes.³⁹⁰ This will ensure that stakeholders have the same understanding of what constitutes dependent agent PE risk. Complexity of dependent agent PE concept shows the need to address it through “tone from the top”. This means essentially the board involvement. Namely, we can observe a strong correlation between success and reputation

³⁸⁸ After Webinar: Permanent Establishment Risks in International Tax Planning and Structuring in the Post-BEPS Era (IFBD, 2017) <<https://www.ibfd.org/Training/Webinar-Permanent-Establishment-Risks-International-Tax-Planning-and-Structuring-Post-BEPS>> accessed 22 October 2018

³⁸⁹ Tax policy (Electrolux, 10 July 2018) 4 <<https://www.electroluxgroup.com/en/tax-policy-22164/>> accessed 22 October 2018

³⁹⁰ John Fraser and Betty J. Simkins (eds), *Enterprise Risk Management: Today's Leading Research and Best Practices for Tomorrow's executives* (John Wiley & Sons, 2010)

of the company which is based on general perception of it.³⁹¹ Making any mistake in ensuring tax compliance will have an adverse impact on the brand, reputation of the board, and, more generally, “social licence to operate” (especially, operate profitably) locally and globally.³⁹² Senior management are striving towards better tax transparency because of potential material impact on financial statements and raise more complex questions on managing tax exposure.³⁹³ Thus, it is important to ensure early and direct communication with CEOs, boards and senior managers about concerns the tax administration may have in relation to how business manages its tax compliance and pays taxes from PE.³⁹⁴

4.7.2. Document management

Results of PwC survey on managing PE risk (2012) have shown that a large majority of respondents had difficulty to monitor how other departments, such as HR and Sales, implement guidance of tax function correctly.³⁹⁵ This shows the need to develop policies and guidelines that are easy to implement and monitor. This brings us to the last aspect of treating dependent agent PE risk – document management.

Aim of the efficient document management is to help the tax function to connect with essential people through drafting and managing clear procedures, ensure understanding of processes and tax data, and equip stakeholders with tools to evaluate present and planned operation models through the tax framework.³⁹⁶ It enables retention, centralisation, management, security and easy access to documents, both in paper and electronic forms.³⁹⁷ Improving oversight, data collection and documentation of where people are, what they are doing and for whom is the key in assessing whether existing operating model is robust

³⁹¹ Bernd Erle, “Tax Risk Management and Board Responsibility” in Wolfgang Schön (eds), *Tax and Corporate Governance*. MPI Studies on Intellectual Property, Competition and Tax Law (Springer, 2008) 206

³⁹² Tax in the boardroom (KPMG, November 2016) 3
<https://home.kpmg.com/content/dam/kpmg/nz/pdf/November/tax-in-the-boardroom-kpmg-nz.pdf> accessed 22 October 2018

³⁹³ General Administrative Principles: Corporate governance and tax risk management (OECD, July 2009) 7
<https://www.oecd.org/tax/administration/43239887.pdf> accessed 22 October 2018

³⁹⁴ General Administrative Principles: Corporate governance and tax risk management (OECD, July 2009) 11
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³⁹⁵ Axel Smits and Isabel Verlinden, “Permanent Establishments 2.0: At the heart of the matter” (PwC, 2013) 7
<https://www.pwc.com/gx/en/tax/publications/assets/pwc-permanent-establishments-at-the-heart-of-the-matter-final.pdf> accessed 21 October 2018

³⁹⁶ Nikhil Hira, “Managing Tax Risks: The Role of the Board: A top – down approach” (ICPAK Governance Conference, 12 April 2013) 12
https://www.icpak.com/wp-content/uploads/2015/09/ICPAK_Corp-Gov_Risk-Mgt_10Apr13_Jona-Copy.pdf accessed 21 October 2018

³⁹⁷ The Tax Function of the Future Enhancing Tax Process Management and Controls – Workflow, Document Management and Collaboration (PwC, 2016) 11
<https://www.pwc.com/gx/en/tax/publications/assets/enhancing-tax-process-managemnt-and-controls.pdf> accessed 22 October 2018

enough to face PE risk challenges.³⁹⁸ Proper documentation equips the enterprise with the means to demonstrate that activities are based on sound business rationale rather than mere realisation of tax savings or even tax avoidance.³⁹⁹ For this reason, contracts should clearly define the core activities of each party to the contract and the contractual rationale should be consistent with business model and other activities or practices of the enterprise.⁴⁰⁰

In assessment of business arrangements on distribution, we can identify following challenges:

- Drafting and reviewing numerous contracts in case of global sales presence
- Management, storage and archiving of contracts
- Review of matching between actual conduct and contractual agreement
- Adjustments of contracts to legal changes.⁴⁰¹

The key tool to address it would be implementation of checklists. Checklists in a form of series of questions or a list of topics (individual or standard checklists) provide a convenient way for management to rapidly identify possible risks.⁴⁰²

4.7.3. Assessment of business arrangements

Efficient document management allows to conduct accurate assessment of business models in light of tax legislation changes. Dependent agent PE risk may arise when the enterprise enters the new market, restructures existing business arrangements, review substantial provisions of contracts or recruit new agents to represent their interests abroad. Mainly, analysis of OECD approach to tax management helps to identify several blocks of questions to assess business arrangements.

Table 8. Distribution model assessment for dependent agent PE risk management purposes.⁴⁰³

³⁹⁸ Joost Vreeswijk and Ai-Leen Tan, “The impact of BEPS Action 7 on operating models” (International Tax Review, 8 March 2016) <<http://www.internationaltaxreview.com/Article/3535787/The-impact-of-BEPS-Action-7-on-operating-models.html>> accessed 21 October 2018

³⁹⁹ Fernanda Antunes Rubim, “Permanent Establishment Risks following Manufacturing and Distributing Restructurings” [2012] 66(6) Bulletin for International Taxation IBFD (accessed 9 December 2016)

⁴⁰⁰ Fernanda Antunes Rubim, “Permanent Establishment Risks following Manufacturing and Distributing Restructurings” [2012] 66(6) Bulletin for International Taxation IBFD (accessed 9 December 2016)

⁴⁰¹ Peter Kits and Pim Gerritsen van der Hoop, “Deloitte TaxLab” (Deloitte Legal, 2017) 24 <<https://www2.deloitte.com/content/dam/Deloitte/nl/Documents/tax/deloitte-nl-tax-tp-documentatie-en-legal-documentatie.pdf>> accessed 22 October 2018

⁴⁰² Tony Merna, Faisal F. Al-Thani and Faisal F. Al-Thani Merna, *Corporate Risk Management* (2nd edn, John Wiley & Sons, Incorporated, 2011) 72

Group 1. Rationale and essence of business arrangements
<ol style="list-style-type: none"> 1. What commercial objectives your enterprise is seeking under proposed structure of agency agreements? 2. What is expected financial benefit? 3. Are the actual/forecasted tax result at odds with expected commercial results? 4. Is proposed/existing agency structure more complex than needed to achieve set commercial objectives? 5. Are there any steps or arrangements in the distribution model designed with a primary goal to avoid taxes? 6. Is the strategy or the details of transactions consistence with the substance of distribution business model?
Group 2. Knowledge management in transaction assessment
<ol style="list-style-type: none"> 1. Is the factual basis of provided analysis fully accurate and correspond with perceptions of all stakeholders? 2. How confident are the key stakeholders about the advice received on managing PE risk (e.g. advice from external sources, such as consultancy)? 3. Is advice based on the actual transaction/business model or expectation how it will be implemented? 4. If the advice is based on assumptions, are these assumptions reasonable and realistic? If these assumptions do not stay true in the eyes of tax authorities, how would this impact the applicability of analysis? 5. Were potential changes taken into account when performing analysis of the transaction?
Group 3. Cooperation with tax authorities
<ol style="list-style-type: none"> 1. How likely is it that tax authority will have different understanding how law should be applied to the business model in question? 2. How material this understanding might be? How can it impact the deemed tax risk profile of the enterprise? 3. How high is the risk of litigation in case if tax authority is not prepared to settle the dispute? 4. If the tax authorities take a different approach, and this disagreement results in litigation, how likely is it that the court decision will favour approach of the tax authority? 5. What will be the downside if the company loses the litigation?

This questionnaire can be used in implementing interviewing technique that provides a means of soliciting information e.g. from project personnel.⁴⁰⁴ It should be used in close connection with strengthening communications across stakeholders.

4.8. Conclusions

Managing PE risk in case of dependent agents has several specifics. First, it depends substantially on understanding nuances of how legal concepts of agency, contracts and obligations are interpreted under domestic law. Second, it requires a deep-dive into

⁴⁰³ General Administrative Principles: Corporate governance and tax risk management (OECD, July 2009) 19 <<https://www.oecd.org/tax/administration/43239887.pdf>> accessed 22 October 2018

⁴⁰⁴ Tony Merna, Faisal F. Al-Thani and Faisal F. Al-Thani Merna, *Corporate Risk Management* (2nd edn, John Wiley & Sons, Incorporated, 2011) 71

economic, not only legal substance of business arrangements due to BEPS Action 7 approach and general trend to lower dependent agent PE threshold.

Testing tax risk management stages on the example of dependent agent PE risk has helped to reach important findings. First, analysis of dependent agent PE risk has shown the increasing tendency of the tax authorities to expore factual and economic nature of arrangements, rather than formal features such as signing the agreement. Moreover, tax planning patterns enabled by digital economy make the legislators to rethink the concept of agent role to lower PE threshold.

In light of this, addressing dependent agent PE risk requires a structured multi-stage approach to ensure engagement all stakeholders and to guarantee the alignment of PE risk management with the general tax governance framework and values of the enterprise.

5. CONCLUSIONS

The research objective of the thesis was to identify main PE risks faced by multinational enterprises at different stages of value chain, with focus on distribution, and explore ways how enterprises can manage these risks through analysing, prioritising and treating the risks.

First, research has uncovered the challenges in balancing roles of PE concept in ensuring both sufficient tax revenue and flexibility for taxpayers. Complexity of PE concept stems from multiple roles it has played historically in ensuring stable source of tax revenue and at the same time, development of cross-border trade. Moreover, the PE definition emerged at the time when business could be carried only through physical place of business, and nowadays digital economy reality that distorts the traditional concept of PE as physical place of presence. Complexity of theoretic approach to PE concept in OECD Model is multiplied by diverse sources of law that may define presence of PE on case-by-case basis – supranational regulations (e.g., the EU law), bilateral and multilateral tax treaties, domestic laws and often unpredictable case law.

Second, research has shown that addressing PE risk requires a deep understanding of tax compliance principles, tax strategy of the enterprise, as well as of key principles and rationale of tax risk management through tax controls framework. Tax risk management is necessary to identify root causes of failing to meet expectations of tax authorities. Namely, tax management allows to identify tax risks at the early stage and analyse them, prioritise what risks to address first and how to treat them. In case of PE risk management, efficient system of monitoring is a necessary stage, as it allows to keep up with changing regulatory environment, especially in light of measures states take after BEPS Action 7. Comprehensive tax risk management framework will ensure that MNE will not overlook risks that are likely to happen due to communication failures, agency problems or misunderstanding of applicable regulations.

Third, looking into dependent agent PE risk as one of the most probable risks in the value chain of enterprise has revealed important aspects that the enterprises should take into account when planning their tax controls. Namely, MNEs should be ready to scrutinize their arrangements with third parties under criteria stated by Article 5(5) of OECD Model Tax Convention and define what criteria are most applicable and pose the greatest risk

exactly for their arrangements. MNEs should pay a special attention to the criterion of habitual conclusion or “principal role leading to conclusion of the contracts” due to determination of tax authorities to explore the real economic substance of transaction model, not just legal formalities. In addition to that, concepts of “agency” and “contracts” itself may receive dubious interpretation under applicable national laws, especially due to differences between civil and common law systems. Risk management framework allows to identify unobvious cases when PE status may be triggered, prioritise risks arising from global employee mobility, storage and distribution arrangements, and address these risks through improving communications with key stakeholders and enhancing document management framework.

Analysis shows three prerequisites of efficient PE risk management for MNEs. First comes the ability to grasp the role, background and upcoming changes in PE concept, and thus, identify expectations of tax authorities in different legal systems. Second is the ability to ensure sufficient document management system that would allow all stakeholders to have accurate understanding of business models that are impacted by legislation changes. Third is the ability to efficiently assess risks arising from concrete business arrangements based on solid understanding of PE concept and effective management of tax-related documentation.

This research did not address such aspects of PE risk analysis as profit distribution of PE, including interpretation of arm's length principle, and dispute resolution mechanism that businesses can revert to. These topics would make the subject of the separate research. However, the tax controls framework helps to have a systematised approach to risk mapping and, therefore, to comprehend the scope of risks even before starting a deeper analysis.

ABBREVIATIONS

AOA	authorized OECD approach
MLI	Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS
OECD	Organisation for Economic Co-operation and Development
OECD Model Tax Convention, OECD Model	OECD Model Tax Convention on Income and on Capital
PE	Permanent Establishment
TCF	Tax controls framework
TRM	Tax risk management

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ANNEX 1. Structure of Article 5 “Permanent Establishment” of OECD Model Tax Convention on Income and on Capital

Note: Highlighting and other formatting added by author. Rows highlighted in blue show changes brought to 2017 OECD Model Tax Convention.

Text	Content and references to research	Changes in comparison with OECD Model Tax Convention 2014
1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.	PE definition (2.2, 2.5)	No
2. The term “permanent establishment” includes especially : a) a place of management; b) a branch; c) an office; d) a factory; e) a workshop, and f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.	Open-ended list of PE examples (2.5)	No
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months .	Construction/Installation PE with duration criterion (2.5)	No
4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include: a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise ; b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery ; c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise ; d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise ; e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character ; f) the maintenance of a fixed place of	Exceptions to general PE rule (activities of “preparatory or auxiliary character” mainly connected with purposes of: <ul style="list-style-type: none"> • “storage, display, or delivery”, • “processing by another enterprise”, • “collecting information”) (2.5, 4.4.7)	No

<p>business <u>solely for any combination of activities</u> mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is <u>of a preparatory or auxiliary character</u>, provided that such activity or, in the case of subparagraph f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.</p>		
<p><i>4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if <u>the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character, provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.</u></i></p>	<p>Provision on closely related enterprises under which exceptions to general PE rule do not apply (4.2, 4.4.7)</p>	<p>Paragraph 4.1 added in OECD Model Tax Convention 2017</p>
<p>5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person – <u>other than an agent of an independent status</u> to whom paragraph 6 applies – is acting in a Contracting State on behalf of an enterprise and has, and habitually exercises, in a Contracting State, an authority to conclude contracts, in doing so, <u>habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise</u>, and these contracts <u>are a) in the name of the enterprise, or b) for the transfer of the ownership of, or for the granting of the right to use,</u></p>	<p>Dependent agent PE: scope and exceptions under Article 5(4) (4.2, 4.3)</p>	<p>(OECD Model Tax Convention 2014) 5. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 6 applies - is acting on behalf of an enterprise and <u>has, and habitually exercises,</u> in a Contracting State an <u>authority to conclude contracts in the name of the enterprise</u>, than enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised</p>

<p><u>property owned by that enterprise or that the enterprise has the right to use, or c) for the provision of services by that enterprise,</u> that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, <u>unless the activities of such person are limited to those mentioned in paragraph 4</u> which, if exercised through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.</p>		<p>through a fixed place of business, would not make this fixed place of business a permanent establishment under provisions of that paragraph.</p>
<p>6. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State <u>as an independent agent and acts for the enterprise in the ordinary course of business.</u></p>	<p>Dependent agent PE rule scope: inapplicability to <u>independent</u> agents (4.4.6)</p>	<p>6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting <u>in the ordinary course of their business.</u></p>
<p>Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises <u>to which it is closely related</u>, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect of any such enterprise.</p>	<p>Provision on closely related enterprises (4.4.7)</p>	<p>Second subparagraph of paragraph 6 added in OECD Model Tax Convention 2017</p>
<p>7. The fact that a company which is a resident of a Contracting State <u>controls or is controlled by a company which is a resident of the other Contracting State</u>, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.</p>		<p>No changes</p>
<p>8. For the purposes of this Article, a person or enterprise <u>is closely related</u> to an enterprise if, based on all the relevant facts and circumstances, <u>one has control of the other or both are under the control of the same persons or enterprises.</u> In any case, a person or enterprise shall be considered to be closely related to an enterprise <u>if one possesses directly or indirectly more</u></p>	<p>Definition and criteria of closely related enterprises (4.4.7)</p>	<p>Paragraph 8 added in OECD Model Tax Convention 2017</p>

<p><u>than 50 per cent of the beneficial interest in the other</u> (or, in the case of a company, <u>more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company</u>) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.</p>		
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